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Corporation Finance

AN EXPOSITION OF THE PRINCIPLES AND METHODS GOVERNING THE PROMOTION, ORGANIZATION AND MANAGEMENT OF MODERN CORPORATIONS

BY

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CHAPTER I

THE CORPORATE FORM

1. *"Non-stock" corporations.*—Everybody knows in a vague way that a corporation is an association of individuals formed to carry on an enterprise. Comparatively few people, however, understand just what the corporation is in the eyes of the law or the extent and the limitations of its activities. Obviously, the first step in the study of corporation finance should be an examination of the powers and possibilities of this peculiar and wonderfully effective form of organization.

Corporations fall into two distinct groups. There are, first, corporations without capital stock, or "non-stock" corporations; to this class belong almost all churches, hospitals, chartered clubs, universities and other strictly social and charitable organizations. The prime characteristic of such corporations is that the members share equally in all the privileges of membership without regard to the amount of money that each may have contributed. There is no arrangement for transacting a money-making business and distributing profits or losses. In fact, non-stock corporations exist either for the common benefit of all the members or for the purpose of serving the public at large. Many interesting questions as to the rights and powers of such corporations might be discussed; but the discussion would be out of place in this volume.

2. *"Stock" corporations.*—We are here concerned only with the second class, namely, "stock" corporations;

to this class belong all business corporations. Two apparent exceptions, mutual insurance societies and stock exchanges, both of which are ordinarily "non-stock" corporations, may be noted; both organizations in their fundamental character, however, are simply clubs which, like many other clubs, offer to their members certain valuable privileges. "Stock" corporations, on the other hand, are formed with the object of carrying on business ventures; they have a capital stock divided into transferable shares; they are intended to make profits which are to be distributed to their members, or stockholders, in proportion to the number of shares each one possesses; each stockholder secures his shares by purchase for valuable consideration from the corporation or by transfer from some previous stockholder; each stockholder is an owner of the corporation and its assets to the extent of the number of shares that he holds.

3. *Definitions.*—The most famous definition of a corporation, and a definition that in its main features is as sound to-day as it ever was, is that given in the Dartmouth College case in 1819 by Chief Justice Marshall of the United States Supreme Court, who referred to a corporation as "an artificial being, invisible, intangible, and existing only in contemplation of law." Blackstone, author of England's greatest legal text-book, gives a definition that is almost as well-known as Chief Justice Marshall's in the following words: "A corporation is an artificial person created for preserving in perpetual succession certain rights which, being conferred on natural persons only, would fail in the process of time." You will note that this definition emphasizes the most striking distinctive feature of the corporation, namely, its artificial personality. The corporation is an entity or being in itself, apart from the persons who organize

and own it. Let us review some of the results of this legal fiction that the creation of a corporation brings into the world a new person,—artificially created, to be sure, but yet endowed with many of the powers of an ordinary human being.

In the first place, as the corporation has an existence apart from the lives of any or all its owners, it is not broken up by the death or withdrawal of any owner. In the second place, the corporation has the right to buy and sell and contract debts in its own name and for itself; it may even owe money or lend money to some or all of its owners. In the third place, it may sue and be sued in the courts, without thereby involving any of its owners. In the fourth place, it may enter into all kinds of legal contracts, just as an individual might do.

4. *The fiction of "corporate entity."*—Here, then, is the first and most fundamental fact about the corporation for the reader to grasp and keep always clearly in view, that it is a separate, distinct artificial person. It is true that within the last few years the courts of the United States have shown a strong tendency to go behind this artificial personality and to throw responsibility on the owners and managers of a corporation, especially in case of fraud. Clark, the author of a standard legal work, says:

> That a corporation is a legal entity, separate and distinct from the members who compose it, is a mere legal fiction, introduced for the convenience of the corporation in transacting business, and of those who do business with it; and, when urged to an intent and purpose not within its reason and policy, the fiction will be disregarded, and the fact that the corporation is really a collection of individuals will be recognized, even at law. Courts of equity, in every instance, look behind the corporate

entity and recognize the individual members and will do so whenever justice requires.

Yet the fact remains that the corporation's existence, property, contracts and debts all adhere to the corporation itself and not to the individuals who together own the corporation. It is true, also, that this artificial person, the corporation, has neither mind nor body and cannot therefore think or act. The law, however, easily gets over this difficulty by treating the managers and officers of the corporation as agents empowered to carry on its operations.

5. *Corporations in ancient nations.*—This fiction of artificial personality seems to be at first sight an unnecessary and even absurd idea, and the results that follow from the adoption of this fiction appear more like the spinning of legal cobwebs than the working out of common-sense principles. But a little further study reveals that the corporate form substantially as it exists to-day has been used by many ancient and modern nations. It seems, therefore, that there must be some good reason or reasons for its widespread use. The archæologists tell us that as far back as the prosperous days of Babylon the inhabitants of that ill-fated country in their commercial transactions used corporations somewhat as we use them now. The Romans also developed and made great use of the corporate form of organizing enterprises. Indeed, it is asserted by Blackstone, and was at one time universally believed, that our modern corporations are descendants in a direct line of the ancient Roman corporations. Although this theory is no longer fully accepted, it remains true that the Roman law with regard to corporations has had considerable influence in the development of our modern corporation law. Without going further into this historical survey,

which is a little outside the scope of this book. [illegible] may lay down this generalization, that in almost every great active commercial nation the corporate form of organization has sooner or later come into existence. It must, then, we may be sure, have some clear and important business advantages.

6. *Popularity in modern times.*—This conclusion is confirmed when we reflect that along with the marvelous business development of the last century there has been apparent a more than proportional increase in the number and importance of corporations. At first only large enterprises, such as railroads, steamship companies and great manufacturing establishments were so organized. Later the smaller factories and wholesale establishments followed the lead of the larger concerns. Finally within the last few years we have witnessed both in Europe and particularly in this country the extension of the movement to small manufacturing and retail establishments. The drift in this direction is so apparent that it need not be dwelt upon at any length. Every reader of this book may look around and see within his own circle numerous concerns in corporate form which were conducted a few years ago by individuals or partnerships. Unless this tendency receives some unexpected check it will not be many years before the corporate form will be adopted by almost every business, large and small, in the United States.

7. *Adaptability to raising large amounts of capital.*—Evidently there must be great advantages in the corporate form; otherwise the landslide toward it would long ago have been stopped. It will be worth while to review briefly some of these advantages.

Originally, as has been said, corporations were confined almost altogether to large enterprises and were used

principally because of the facilities which they afforded for raising and handling large amounts of capital. In this respect they are obviously far superior both to individuals and to partnerships. Not even the richest individual—not John D. Rockefeller nor Andrew Carnegie nor Lord Rothschild—would be able out of his own resources to build and operate one of the great railroad systems of the United States. Even if one of these men were able individually to take care of an enterprise of this size, he would not care to do it. Men of great wealth do not consider it advisable to put all their money into one business. They scatter their investments, so that if one proves a failure profits on the others may more than counterbalance the loss.

Nor would a partnership, great and wealthy as some partnerships have been, be an efficient method of bringing together the vast amounts of capital that are required for every great enterprise. It would be an extraordinary coincidence if several men of immense wealth, who might conceivably construct and own in partnership a big railroad or a big industrial trust, were able to harmonize inevitable differences of opinion and to co-operate efficiently in a partnership arrangement. It is probably safe to say that in the whole commercial history of the world we could not find a single instance of, say, a billion or even half a billion—perhaps even a hundred million—dollars of capital raised and managed under a partnership agreement. It is well to remember in this connection that even the greatest individual fortunes are mere dots compared to the total wealth of a vast country like the United States. Furthermore, of these individual fortunes only a small part ordinarily is free at any one time to be used or invested as the owner wills.

The corporate form, on the other hand, has infinite possibilities so far as the raising and managing of capital is concerned. Any number of people, large or small, may contribute funds. The American Telephone and Telegraph Company, for example, has over 54,000 stockholders, the Pennsylvania Railroad Company over 84,000, and the United States Steel Corporation not far from 125,000. A large number of owners of a corporation does not tend to break up and render inefficient the management, for the control of whatever capital the owners contribute is kept in the hands of the officers of the corporation. Thus the corporation, without losing in efficiency, may reach out into the highways and by-ways of the land, draw its capital from a thousand or from a hundred thousand individuals and heap up vast aggregations of capital that could not possibly be obtained in any other manner. For this reason it is inevitable that the corporate form should be used in the financing of practically every large enterprise.

This advantage of corporations, that they are able to collect and to make use of the small contributions of many individuals, though most prominent in great undertakings, is by no means to be overlooked in the case of smaller enterprises. Frequently an inventor or a retail dealer or any small business man who needs a few hundred or a few thousand dollars, could not obtain it from his own immediate relatives and friends. The same man, perhaps, may easily raise the capital he requires by organizing a corporation and selling small interests to a considerable number of people. Many a business man has thus obtained necessary capital which he has made the foundation of a fortune.

8. *Permanence.*—The second important advantage

of the corporate form is permanence. When an individual owner of a business dies, his business dies with him. It may, to be sure, be carried on by his family or bought by strangers; on the other hand, it may be that no practicable method of disposing of it except at an enormous sacrifice will be found. This is largely a matter of chance, because no organization for carrying on the business is in existence. A partnership is almost equally subject to chance. When a partner dies, the firm is thereby automatically dissolved. The surviving partner or partners may, of course, form a new firm and take over the interest of the deceased partner. In so doing, however, disputes are liable to occur, especially in those lines of business where the earnings are irregular and the value of the assets is not clearly defined. If the surviving partners are unable to continue the business properly or are disposed to drive a hard bargain, the estate of the deceased partner may be deprived of a large part of its rightful interest in the business. Here, again, there is no permanent machinery for managing the business. The partnership, like the individual business, is subject to all the uncertainties and calamities that beset the lives of individual human beings.

The corporation, on the other hand, exists until it becomes bankrupt, is allowed to lapse or is voluntarily dissolved. The death of any man, even if he owns 99 per cent of the stock of the corporation, does not affect the corporation itself. It is an "artificial being," a creature of the law not subject to the infirmities of human existence. It is so organized that if one officer dies or withdraws, a successor may be quickly chosen. As the corporation exists apart from the persons who own it and as control is vested in its officers, the death or withdrawal of an owner does not at all disturb its

machinery, and the death or withdrawal of an officer means simply that someone else must be found and appointed to the position.

9. *Centralization of control.*—This brings us to the third important advantage of the corporate form, namely, its centralization of power and responsibility. In this particular feature it cannot be, of course, superior to individual ownership, but it is far ahead of the partnership. As the law does not recognize in the partnership anything but a group or association of individuals, it follows that each partner is empowered to conduct the business, to buy and sell the partnership assets, to make binding contracts and incur debts. Ordinarily, to be sure, the partners mutually agree to a fixed division of duties and powers, but this division is not supposed to be known or to be binding on outsiders. Each partner, so far as his dealings with outsiders are concerned, is the whole partnership. Obviously, therefore, no partnership should ever be formed except between persons who have entire confidence in each other; and even then a partnership often proves an unsafe and inefficient method of conducting business. Except by mutual agreement binding only on themselves, to repeat, there is no clear-cut division of powers and responsibilities.

Under the corporate form, on the other hand, business can be transacted only by the duly appointed officers; no owner, unless he is also an officer—even though he hold almost all the stock—has any authority to transact business for the corporation. Each of the officers of the corporation, as is explained in the chapter on "Interior Organization," has his sphere of duties carefully defined, both within the corporation and outside. Persons not connected with the corporation are expected

to have their dealings only with the duly authorized officers, and if they do not exercise reasonable care in this respect may find whatever agreements or contracts they make invalid. This will be more clearly understood by the reader after a study of the chapters on agency in the volume on COMMERCIAL LAW. Furthermore, the relations of the corporate officers to each other are clearly defined and the gradations of authority are so marked that each one may understand clearly just how far he is empowered to act on his own judgment and what questions he should refer to his official superiors. The great advantage of this care in organization and in delegation of power is so obvious that it need not be dwelt upon at any length. A well-managed corporation carries on its affairs with the precision and smoothness of a well-disciplined army.

10. *Transferability of ownership.*—A fourth advantage of the corporate form is the ease with which its ownership may be transferred. An individual owner who desires to sell his property must find a purchaser for all of it at one and the same time. A partner who desires to sell his interest in the firm must either make some satisfactory arrangement with the other partners, which may be a difficult matter, or must find a purchaser who offers satisfactory terms and is personally acceptable to the other partners, and that is likely to prove still more difficult. Altogether the problem of withdrawing funds that have been invested in an individually-owned property or in a partnership is almost always hard and frequently insoluble. Under the corporate form the problem is much simpler. The ownership of a corporation is represented by shares, any or all of which may be transferred from hand to hand without interfering in the least with the stability of the corporation. An owner

of several shares need not, therefore, find any one person to take all his property off his hands; he may sell a few shares to one man, one or two to another, and so on, and thus dispose of his property piecemeal. Furthermore, as the corporation is managed directly by the officers, not by the owners, no consideration ordinarily need be given to the question as to whether or not a prospective buyer is a good business man or is acceptable to the other persons interested in the corporation. Women, old men, administrators and trustees of estates, institutions of all kinds—all are possible purchasers of corporate securities. Thus the owner of corporate shares finds his market much broader and his facilities for selling much better than does the owner of a partnership interest. The securities of large corporations are constantly dealt in on the stock exchanges of large cities, and thus a continuous and easily accessible market is afforded to every owner.

11. *Limited liability.*—The fifth and last important advantage of the corporate form is the fact that the liability and possible loss of each owner is limited. Generally speaking, the owner of any corporation security is safe in reflecting that, though the security may become worthless and he may lose all that he paid for it, he cannot possibly lose more than that amount. The reader may perhaps think that to the owner of the stock of a failed corporation this statement affords but cold comfort; but compare his situation with that of a partner in a bankrupt firm. The partner may not only lose all that he invested in the firm, but in addition is personally liable for all the unpaid debts of the firm. As has been explained above, it is possible that these debts may have been foolishly or even fraudulently contracted by some other partner; yet that fact would not relieve any other partner from his personal liability. No doubt most

readers of this paragraph will call to mind instances in their own experience of individual owners or of partners in disastrous enterprises who have lost everything they owned, including even their homes and most of their personal property, by the failure of such enterprises. If a corporation fails, on the other hand, and its debts prove greater than its assets, the creditors have no claim on the property of the stockholders outside the failed business.

An important exception to this principle of limited liability exists in the case of stockholders of national banks. They are individually liable in case of failure not only for their investment but for an additional sum equal to the par value of their holdings of bank stock. A similar rule applies in Minnesota to stockholders of most corporations and there are one or two other exceptions which are referred to in Chapter IV. Even in such cases, however, though the liability of stockholders is somewhat greater than with the ordinary corporation, it is still strictly limited.

No doubt this principle of limited liability has been one of the main advantages of corporations that has led to their formation in a great many cases, and especially has encouraged in recent years the widespread movement to change partnerships into corporations. No business man, especially one who has considerable personal property and perhaps is advanced in years, likes to reflect that at any moment, through the fraud or mismanagement of some subordinate or partner, or through some unavoidable natural calamity, he may be compelled to give up his home and personal property in order to satisfy the demands of business creditors. The corporate form of business relieves him of this haunting spectre.

The prominent advantages of the corporate form, which have brought about its great extension in recent years, may then be summed up as follows:

(1) FLEXIBILITY. The owners of a corporation may be few or numerous. This makes the corporate form especially well adapted to collecting large amounts of capital by means of small contributions from a great many people.

(2) PERMANENCE. The life of a corporation is not dependent on the life or on the caprice of any individual.

(3) CENTRALIZATION OF CONTROL. Under the corporate form the officers of the corporation within carefully defined limits exercise complete control.

(4) TRANSFERABILITY OF OWNERSHIP. Corporate shares may be readily sold either in a block or piecemeal and have a wide market.

(5) LIMITED LIABILITY. The corporation alone, with certain minor exceptions, is liable for its own debts and the shareholders cannot lose more than their original investment.

12. *Disadvantages of the corporate form.*—In view of these advantages it may be asked why all kinds of business without exception are not organized under the corporate form. The answer is that certain minor disadvantages, which in some instances are sufficient to offset the advantages named, are inseparable from corporations. These disadvantages may be briefly summed up as follows:

(1) INCREASED EXPENSE. All states impose certain incorporation fees, license and franchise taxes on corporations, which taxes are in addition to the ordinary state and local taxes on property. These taxes are, however, uniformly small. The United States Government also imposes a tax on corporate income. In addition,

legal assistance is almost always necessary in forming corporations, and there may be an additional charge on this account of from $25 up. These corporate expenses are, of course, too slight to be worth much consideration, except in the case of very small enterprises, where they may sometimes be of sufficient importance to prevent the adoption of the corporate form.

(2) LIMITED POWERS. As the corporation derives all its powers from the state in which it is incorporated, and as all its powers should be distinctly stated in its articles of incorporation (see Chapter II), it may be somewhat hampered at times by lack of authority to carry on operations that would be profitable. This, however, is a superficial objection that may be readily dismissed; for a good corporation lawyer will always find it possible to include in the statement of the powers of the corporation authority for every act that would be necessary in practice. If not, it is always easy to form a new corporation or amend the charter to cover whatever action is desired. This point also is further discussed in Chapter II.

(3) LIMITED CREDIT. A lender of money would, of course, prefer, other things being equal, to lend to an individual or a partnership, rather than to a corporation, because the liability of the owners of the property in the former case is unlimited, and in the latter case, as has been explained, is limited. Thus a partnership which is converted into a corporation will sometimes be embarrassed more or less by reluctance of its creditors to continue extending credit as freely as before the conversion. This objection, which is of importance usually only in the case of a small and closely held business, may be overcome, if desired, by the officers or certain stockholders personally endorsing the corporation's notes and bills payable. By so doing they, of course, lose the

advantage of limited liability, but they retain all the other advantages of the corporate form. There are some business activities, however, in which the personal element is so prominent as to make unlimited liability desirable. A firm of accountants, for instance, could not be changed to a corporation without forfeiting to some extent the confidence of the business public, for every public accountant is and ought to be personally liable to the fullest extent for the honesty and accuracy of his work. The same thing may be said of bankers and engineers, and to some extent of business advisers and systematizers; for such activities the corporate form, on account of its limited liability feature, is ill-adapted.

(4) Governmental control. Some concerns are strongly averse, for good reasons, to any publicity whatever as to their operations and financial results. They may perhaps be making so much money that they desire to keep it secret in order to avoid attracting competitors; or their real business may be quite different from their ostensible business, and they would not desire to attract attention to this fact by the inclusion of unusual powers in articles of incorporation. For fear of governmental supervision, therefore, they retain the partnership, even with all its disadvantages.

The reader will readily see that this list of disadvantages of the corporate form does not include anything of great importance to most legitimate kinds of business. Certainly the disadvantages are of little weight in most cases in comparison with the obvious and substantial gains that may be had by adopting the corporate form. We are justified in concluding, therefore, that the tendency toward the corporate form of conducting business, which has been referred to above, will not diminish, but rather will increase in the coming years. The

corporation is the efficient twentieth century means of conducting business. In city and in country, from the captains of finance to the smallest units in the army of business, in transportation, in manufacturing, in trading, even in farming, the corporation has come to be recognized as the best form yet discovered for organizing the production of wealth.

To confess oneself ignorant of the nature, the functions, the abuses and the possibilities of this mighty instrument is indeed a confession of business inefficiency and narrowness. The pages that follow are to be devoted to a discussion of the formation and management of corporations which, it is hoped, will place this truly important and somewhat difficult subject in a clear light before our readers.

CHAPTER II

LEGAL STATUS OF THE CORPORATION

13. *Defining and controlling instruments.*—The corporation, we have said, is a "creature of the law," and this statement is to be taken literally. This artificial creature has no existence, no powers, no privileges, no duties, except those which are conferred upon it either by express statement or by implication. The artificial creature, in other words, does not have what we may call the natural rights of an individual to live unmolested and to pursue whatever objects he pleases, so long as the rights of others are not interfered with, but only artificial rights. In order to determine in any particular case, therefore, what a corporation may or may not do and what its standing is, we must look to the particular instruments which give it being and control its actions. These instruments in every state in the Union are three in number:

(1) The Constitution of the state.

(2) The General Corporation Act.

(3) The Charter of each particular corporation.

Supplementing the charter, practically all corporations have a set of by-laws for their own guidance. In order to understand the legal status of a corporation we must consider briefly each of these instruments.

14. *Common law of corporations.*—It must be borne in mind, in connection with what follows in this chapter, that corporations of one kind or another have been in existence for a very long time, and that the courts of England and of the United States have given a large

number of decisions dealing with the duties and powers of corporations. These decisions form the great body of common law with reference to corporations; and this common law, for which search must be made through the precedents of many years, governs where it is not superseded. Corporations as forms of business organization, however—and especially as forms of organization for relatively small enterprises—are comparatively modern. From the very beginning the English Parliament and the state legislatures of this country have found it expedient to enact statutes in order to define clearly the powers and duties of corporations. These statutes in every state are now so explicit and comprehensive as to govern the great mass of corporate activities. They form the body of statutory law with reference to corporations. The reader will find in the volume on COMMERCIAL LAW a full exposition of the relations between common and statutory law and of the manner in which statutes of the legislature are interpreted by the courts. For our purpose it is enough to say that the statute law supersedes the common law wherever the two disagree and that statute law with regard to corporations is so voluminous that we need rarely go back of it to the common law.

15. *The state constitution.*—The fundamental law in each state of the Union is the constitution of the state, and no provision which conflicts with any clause in the state constitution will be legal. This is a point, not merely of theoretical, but also at times of distinct practical importance. For instance, the Constitution of the State of Pennsylvania prescribes that all Pennsylvania corporations shall elect their officers by what is known as "cumulative voting"—a method that is described at some length in Chapter V. In one case, with which

the writer happens to be familiar, certain stockholders of a small Pennsylvania corporation planned to pass a rule against cumulative voting and by means of that rule to elect all members of the board of directors. Great was their chagrin and surprise when they discovered that no Pennsylvania corporation is competent to enforce such a rule as they proposed. It frequently happens that some of the ordinary statute provisions of a state are found, when tested in the courts, to be in conflict with some provision of the state constitution and therefore null and void. The reader, then, should not forget that behind every enactment of the legislature looms the constitution of the state, a fundamental factor that should not be left out of his reckoning.

16. *Method of creating the corporation.*--The direct legislative authority to create a corporation may be given in one of two ways, by special enactment of the legislature for the benefit of this particular corporation, or by a general act which governs the creation of all corporations. Formerly the first named method was universal. It proved itself, however, both inconvenient and unfair. Authority to incorporate was granted arbitrarily by the legislature for certain enterprises and denied to others equally deserving. It was necessary to have a "pull" in order to get the desired enactment. Favoritism and corruption, coupled with unwise conservatism, were the natural results of this method. It has therefore fallen into disuse and is definitely prohibited by the constitutions of many states of the Union. One rather conspicuous exception to the general rule that corporations are no longer formed and managed under the provision of special enactments is the Bay State Gas Company, a corporation organized by Mr. J. Edward Addicks, and later controlled, it is understood, by Mr. Thomas W.

Lawson. This company was given large powers and privileges by a special act of the Legislature of Delaware during the time when Mr. Addicks was reputed to be the political boss of the State.

The present-day method of creating the corporation is by complying with the provisions of a general corporation act—in some states called an "enabling act." Such an act usually prescribes the general purposes for which corporations may be lawfully formed, the chief powers which they may possess—such as power to hold property in the parent and in other states, power to hold its own stock, power to hold stock of other corporations (not conferred by all states), power to borrow money, power to do business in other states, and so on—the number of incorporators and stockholders, the manner and lawful purposes of issue of capital stock, the rights of the stockholders, the minimum numbers of directors and of officers, the character and amount of taxes, the nature of reports required, the exact form to be followed in incorporating, and so on. Under such a general act any citizens of the state—sometimes of other states—who meet the requirements of the law may form a corporation. Thus the favoritism and corruption incident to the old method of special enactment are eliminated. The universal establishment of these general corporation acts is one of the most important reforms in business methods of the second half of the nineteenth century. Though many of these acts—as is pointed out in Chapter IV—are far from perfect, we all have reason to be profoundly thankful that they exist at all.

17. *Essential features of the charter.*—We come now to the immediate instrument of incorporation, the

charter—sometimes called the certificate of incorporation or the articles of incorporation. Where the charter is obtained under a general corporation act, it is drawn by the incorporators or their attorney and presented to the proper state official, usually the secretary of state. If the charter as drawn is approved, the secretary of state signifies his acceptance thereof, and the corporation comes into being. There is no favoritism in this procedure, as there is in the granting of charters by special acts; the secretary of state has no authority to refuse any charter which is properly drawn and which complies with the provisions of the state law.

A charter need not be a very lengthy instrument, although large companies sometimes find it desirable to prevent future misunderstanding by inserting into the charter a great many details not absolutely essential. In practically all states every charter must contain, among other things, the following information:

(1) The name of the corporation.

(2) The purpose or purposes for which it is formed.

(3) The amount of capital stock, and if there is a division into classes of stock, the rights of each class.

(4) The number of shares of stock.

(5) The location of the principal business office.

(6) The period of existence of the corporation, which is usually unlimited or perpetual.

(7) The names and usually the post-office addresses of the incorporators.

If the reader desires a more detailed statement of the requirements in any particular state, he cannot do better than to go direct to the statutes of that state. It would lead us too far afield if we were to enter here on any comprehensive legal study of charter forms and provi-

sions. A few remarks, however, as to the essential features of a charter and the presentation of the sample form following will not be out of place and will help to make clear some points of corporation practice that might otherwise be obscure.

18. *A sample charter.*—The following is a very brief and simple charter, which conforms to the laws of the State of New Jersey. The form in other states would be slightly different. The writer is indebted to Mr. Thomas Conyngton for permission to copy this form from his manual "The Modern Corporation."

CERTIFICATE OF INCORPORATION
OF THE
CARHART DRUG COMPANY.

We, the undersigned, for the purpose of forming a corporation under and by virtue of the provisions of an act of the Legislature of the State of New Jersey, entitled "An Act concerning corporations (Revision of 1896)," and the several supplements thereto and acts amendatory thereof, do hereby severally subscribe for and agree to take the number of shares of stock of the said corporation hereinafter placed opposite our respective names, do further certify and set forth as follows:

First—The name of said corporation shall be

"CARHART DRUG COMPANY."

Second—The location of its principal office in the State of New Jersey shall be at No. 15 Exchange Place, Jersey City.

The name of the agent who shall be therein and in charge thereof, upon whom process against this Corporation may be served, is the Corporation Trust Company of New Jersey.

Third—The objects for which this corporation is formed are:

(a) To manufacture, prepare, compound, mix, combine, buy, sell and generally deal in all manner of

chemicals, chemical products, drugs and pharmaceutical compounds and preparations, and to patent, register or otherwise protect the same.

(b) To obtain, purchase or otherwise acquire formulæ, patents and secret processes for the manufacture and preparation of chemicals, drugs and the compounds and preparations thereof, and to operate under, sell, assign, grant licenses in respect of, or otherwise turn the same to account.

(c) To enter into, carry out or otherwise turn to account contracts of every kind; to have and maintain offices within and without the State; to acquire, hold, mortgage, lease and convey or otherwise use or dispose of real and personal property in any part of the world; and in general to carry on such operations and enterprises and to do all such things in connection therewith as may be permitted by the laws of New Jersey and be necessary or convenient in the conduct of the Company's business.

Fourth—The total authorized stock of the corporation shall be twenty-five thousand dollars ($25,000), divided into two hundred and fifty (250) shares of the par value of one hundred dollars ($100) each, and the amount of capital stock with which said corporation will begin business is five thousand dollars ($5,000).

Fifth—The names and post-office addresses of the incorporators and the number of shares subscribed for by each are as follows:

Names	Addresses	Shares
Willis J. Carhart . . .	15 Exchange Place, Jersey City, N. J.	40
Sheldon McCammis .	" " " " " " "	5
John B. Whelan . . .	" " " " " " "	5

Sixth—The period of existence of said corporation shall be unlimited.

In Witness Whereof, we have hereunto set our hands and

seals this 21st day of July, A. D. nineteen hundred and eight.

Willis J. Carhart. (L. S.)
Sheldon McCammis. (L. S.)
John B. Whelan. (L. S.)

In the presence of
Harmon Watson.
Thomas O'Connell.
(Execution in due form.)

19. *The corporate name.*—The name of a corporation is part of its property and sometimes—especially after the corporation has been long enough established to have acquired good will—is highly valuable property. For that reason, a new corporation is not allowed to assume a name already taken by a previously existing corporation nor even a name so similar as to cause confusion. If the older corporation, however, in such a case were not incorporated or licensed in the same state as the new company, the state authorities would have no right to reject the new company's charter on account of the similarity in name. Under such circumstances the only remedy of the older company would be to bring suit in the courts. Some states lay down certain arbitrary rules, such as that the prefix "The" must be used, or that the word "incorporated" or "limited" must follow the corporate name. Alabama, Colorado, Kentucky, Connecticut, Delaware, Kansas, Missouri, North Carolina and Virginia require the word "company" to be a part of the corporate name. As a matter of business, it is usually very desirable for a new corporation to adopt some distinctive, self-explanatory, short name, and to avoid so far as possible hackneyed words and phrases.

20. *The corporate purposes.*—There is no more important section of the charter than that in which the

corporate purpose or purposes are stated. For most corporations, the activities of which are to be confined to some one line of business, a brief and simple statement is all that is necessary. The incorporators and their attorney should bear in mind in this connection, however, that it costs nothing at the beginning to insert a very full and comprehensive description of all the possible activities of the corporation and that the absence of the right word or phrase may at some future time cause serious inconvenience. The corporation is not obliged to carry out all of the purposes named in the charter; on the other hand, it has no authority to do anything which is not so named or clearly implied. The courts, to be sure, are generally liberal in their interpretation of the implied powers of corporations; but it is better to keep out of the courts and to take a little care at the beginning so as to avert any future disputes as to whether proposed activities are beyond the purposes and powers of the corporation or not.

To illustrate the care with which the purposes of a large company are stated in order to comprehend and give legal authority for any possible future activity, the charter of the United States Steel Corporation, which was drawn by one of the great corporation lawyers of the country, the late James B. Dill, of New Jersey, may be cited. The section of the charter, in which the purposes of this great corporation are stated, is too long to be quoted in full. Nine paragraphs are devoted to describing all the manufacturing, landowning, mining, trading, contracting, inventing and patenting, security-buying, selling and holding activities which could be thought of by all the eminent lawyers and business men who helped Judge Dill to draw the charter. Then follow the two paragraphs quoted below, in which, as

the reader will observe, the incorporators aim to provide for any other possible activity not already distinctly set forth. Note particularly the italicized clauses. A statement somewhat similar to these two paragraphs might be included to advantage in the charters of many much smaller corporations, and perhaps would dispose of otherwise troublesome questions of authority.

The business or purpose of the Company is from time to time to do any one or more of the acts and things herein set forth; and it may conduct its business in other States and in the Territories and in foreign countries, and may have one office or more than one office, and keep the books of the company outside the State of New Jersey, except as otherwise may be provided by law; and may hold, purchase, mortgage and convey real and personal property either in or out of the State of New Jersey.

Without in any particular limiting any of the objects and powers of the corporation, it is hereby expressly declared and provided that the corporation shall have power to issue bonds and other obligations in payment for property purchased or acquired by it, or for any other object in or about its business; to mortgage, or pledge any stocks, bonds, or other obligations, or any property which may be acquired by it, to secure any bonds or other obligations by it issued or incurred; to guarantee any dividends or bonds or contracts or other obligations; to make and perform contracts of any kind and description; and in carrying on its business, or for the purpose of attaining or furthering any of its objects, *to do any and all other acts, and things, and to exercise any and all other powers which a copartnership or natural person could do and exercise, and which now or hereafter may be authorized by law.*

A further illustration of the importance of a clear and full statement in the charter of the purposes for which a corporation is organized is contained in a decision of the New Jersey Court of Errors and Appeals handed down March 5, 1909. The case involved the right of a rail-

road company to acquire and hold the stock of certain trolley companies near Atlantic City. The court denied this right and said, among other things:

The power to purchase, hold, etc., stock and bonds of other corporations conferred by Section 51 of the general corporation act is to be exercised subject to the limitations imposed by Section 2 of the same act; that is to say, the power exists as a primary power only when the purpose to exercise it as such is expressed in the certificate of incorporation; and otherwise it exists as an incidental power only so far as necessary or convenient to the attainment of the objects that are set forth in the charter or certificate of incorporation. It is only by reference to the certificate of incorporation that the Attorney General and other officials interested on behalf of the people can readily determine what powers have been granted and whether the company is usurping franchises not granted by the state. It is by reference to the articles of association that investors can conveniently ascertain the character of the contract into which they are entering and the property rights they are acquiring in purchasing stock of the company.

It must not be forgotten that stock ownership by one company in another is only a mode by which the former company engages in the business of the latter. But since the second company (if Section 51 were unqualified in its effect) might likewise hold stock in any other corporation or corporations, and these might do the same *ad infinitum*, stock ownership in any company under such a system would not evidence a participation in any definite kind of business, but in effect a participation in a "blind pool" subject to the uncontrolled will of the majority. There would be an end at once of all practical force to the doctrine that incorporation evidences a contract between the state and the corporation or between the corporators and stockholders themselves.

Evidently the eminent lawyers who drew up the charter, or certificate of incorporation, of the railroad

company in this instance were either careless or lacking in foresight. Otherwise, they would have avoided this adverse decision very easily by including among the powers granted by the charter the right to acquire and hold stock.

21. *Other important features of the charter.*—The amount of capital and the number of shares of a new corporation which are desirable depend on principles of capitalization that are discussed in Chapter VII and which need not be considered at this stage.

Most, though not all, of the state laws require that the principal office of the corporation shall be within the state where the charter is secured. Partly for this reason, other things being equal, it is better to secure a charter from that state in which most of the business of a corporation is carried on; but this is by no means an invariable rule, as will be pointed out in Chapter IV. It is also usual, although not universal, to provide that one or more of the incorporators shall be citizens of the state which grants the charter. The minimum number of incorporators in most states is three.

The number of directors of a new corporation is an important point to consider when the charter is obtained. Sometimes the number is stated not in the charter, but in the by-laws and may readily be amended from time to time; but where the number is fixed by the charter it cannot be easily changed. A small board obviously is apt to be more efficient than a large board. This is another question which will come up for fuller discussion in a subsequent chapter.

22. *The by-laws.*—The by-laws are simply a collection of permanent rules for transacting business adopted by the stockholders or directors. It is not absolutely necessary, though almost always very desirable, that a

corporation should have by-laws. The by-laws usually contain provisions as to:

(1) Issue and transfer of stock.
(2) Meetings of stockholders and directors.
(3) Election of directors and officers.
(4) Powers and duties of directors and officers.
(5) General directions as to the management of the corporate property.

As in the case of the charter, we will run over briefly some of the important features of corporate by-laws.

First, the reader should study with care the following set of by-laws, which is used by a New York corporation, but could be adapted with slight changes to any small company. This set is taken from Mr. Conyngton's excellent manual, "The Modern Corporation."

BY-LAWS
OF THE
STANDARD BLEACHING COMPANY,
NEW YORK CITY

Article I.—Stock.

1. Certificates of Stock shall be issued in numerical order from the stock certificate book, be signed by the President and Treasurer and sealed by the Secretary with the corporate seal. A record of each certificate issued shall be kept on the stub thereof.

2. Transfers of Stock shall be made only upon the books of the Company and before a new certificate is issued the old certificate must be surrendered for cancellation. The stock books of the Company shall be closed for transfers twenty days before general elections and ten days before dividend days.

3. The Treasury Stock of the Company shall consist of such issued and outstanding stock of the Company as may be donated to the Company or otherwise acquired, and shall be held subject to disposal by the Board of Directors. Such stock

shall neither vote nor participate in dividends while held by the Company.

Article II.—Stockholders.

1. The Annual Meeting of the stockholders of this Company shall be held in the principal office of the Company in New York City at 12 M. on the second Monday in January of each year, if not a legal holiday, but if a legal holiday then on the day following.

2. Special Meetings of the stockholders may be called at the principal office of the Company at any time by resolution of the Board of Directors, or upon written request of stockholders holding one-third of the outstanding stock.

3. Notice of Meetings, written or printed, for every regular or special meeting of the stockholders, shall be prepared and mailed to the last known post-office address of each stockholder not less than ten days before any such meeting, and if for a special meeting, such notice shall state the object or objects thereof. No failure or irregularity of notice of any regular meeting shall invalidate such meeting or any proceeding thereat.

4. A Quorum at any meeting of the stockholders shall consist of a majority of the voting stock of the Company, represented in person or by proxy. A majority of such quorum shall decide any question that may come before the meeting.

5. The election of Directors shall be held at the annual meeting of stockholders and shall, after the first election, be conducted by two inspectors of election appointed by the President for that purpose. The election shall be by ballot, and each stockholder of record shall be entitled to cast one vote for each share of stock held by him.

6. The Order of Business at the annual meeting, and, as far as possible, at all other meetings of the stockholders, shall be:

1. Calling of Roll.
2. Proof of due notice of Meeting.
3. Reading and disposal of any unapproved Minutes.
4. Annual Reports of Officers and Committees.

5. Election of Directors.
6. Unfinished Business.
7. New Business.
8. Adjournment.

Article III.—Directors.

1. The Business and Property of the Company shall be managed by a Board of seven Directors, who shall be stockholders and who shall be elected annually by ballot by the stockholders for the term of one year, and shall serve until the election and acceptance of their duly qualified successors. Any vacancies may be filled by the Board for the unexpired term. Directors shall receive no compensation for their services.

2. The Regular Meetings of the Board of Directors shall be held in the principal office of the Company in New York City at 3 P. M. on the third Tuesday of each month, if not a legal holiday, but if a legal holiday, then on the day following.

3. Special Meetings of the Board of Directors to be held in the principal office of the Company in New York City may be called at any time by the President, or by any three members of the Board, or may be held at any time and place, without notice, by unanimous written consent of all the members, or with the presence of all members at such meetings.

4. Notices of both regular and special meetings shall be mailed by the Secretary to each member of the Board not less than five days before any such meeting, and notices of special meetings shall state the purposes thereof. No failure or irregularity of notice of any regular meeting shall invalidate such meeting or any proceeding thereat.

5. A Quorum at any meeting shall consist of a majority of the entire membership of the Board. A majority of such quorum shall decide any question that may come before the meeting.

6. Officers of the Company shall be elected by ballot by the Board of Directors at their first meeting after the election of directors each year. If any office becomes vacant during the year, the Board of Directors shall fill the same for the unex-

pired term. The Board of Directors shall fix the compensation of the officers and agents of the Company.

7. The order of business at any regular or special meeting of the Board of Directors shall be:

1. Reading and disposal of any unapproved Minutes.
2. Reports of Officers and Committees.
3. Unfinished Business.
4. New Business.
5. Adjournment.

Article IV.—Officers.

1. The Officers of the Company shall be a President, a Vice-President, a Secretary and a Treasurer, who shall be elected for one year and shall hold office until their successors are elected and qualify. The positions of Secretary and Treasurer may be united in one person.

2. The President shall preside at all meetings, shall have general supervision of the affairs of the Company, shall sign or countersign all certificates, contracts and other instruments of the Company as authorized by the Board of Directors; shall make reports to the directors and stockholders and perform all such other duties as are incident to his office or are properly required of him by the Board of Directors. In the absence or disability of the President, the Vice-President shall exercise all his functions.

3. The Secretary shall issue notices for all meetings, shall keep their minutes, shall have charge of the seal and the corporate books, shall sign with the President such instruments as require such signature, and shall make such reports and perform such other duties as are incident to his office, or are properly required of him by the Board of Directors.

4. The Treasurer shall have the custody of all moneys and securities of the Company and shall keep regular books of account and balance the same each month. He shall sign or countersign such instruments as require his signature, shall perform all duties incident to his office or that are properly required of him by the Board, and shall give bond for the faithful perform-

ance of his duties in such sum and with such sureties as may be required by the Board of Directors.

Article V.—Dividends and Finance.

1. Dividends shall be declared only from the surplus profits at such times as the Board of Directors shall direct, and no dividend shall be declared that will impair the capital of the Company.

2. The moneys of the Company shall be deposited in the name of the Company in such bank or trust company as the Board of Directors shall designate, and shall be drawn out only by check signed by the Treasurer and countersigned by the President.

Article VI.—Seal.

1. The Corporate Seal of the Company shall consist of two concentric circles, between which is the name of the Company, and in the centre shall be inscribed "Incorporated 1905, New York," and such seal, as impressed on the margin hereof, is hereby adopted as the Corporate Seal of the Company.

Article VII.—Amendments.

1. These By-Laws may be amended, repealed or altered, in whole or in part, by a majority vote of the entire outstanding stock of the Company, at any regular meeting of the stockholders, or at any special meeting where such action has been announced in the call and notice of such meeting.

2. The Board of Directors y adopt additional by-laws in harmony therewith, but shall not alter nor repeal any by-laws adopted by the stockholders of the Company.

23. *Essential features of the by-laws.*—The sections with regard to stock are usually of a formal character and state simply that the ownership of stock shall be evidenced by the issue of certificates to each stockholder, and that transfers of ownership shall be made only upon the books of the company. The reader should thoroughly understand this provision, which is practically universal. Frequently the engraved certificate of stock

in the possession of a stockholder, which usually reads "This is to certify that John Doe is the owner of . . shares of the capital stock of the John Doe Company, transferable only on the books of the company, etc.," (see page 96) is incorrectly called and mistaken for stock itself. As a matter of fact, stock is an intangible thing; it is merely a right to a share in the company's assets and earnings. A certificate is only a convenient method of proving that a certain person is the owner of stock. A certificate may be lost or stolen or given away or sold and yet the ownership of the stock will remain unchanged. Only by transfer on the books of the company will a change in ownership be consummated. The usual method of transferring stock is to sign a blank form on the back of each certificate (see page 96) which authorizes the secretary of the corporation or some other agent of the owner to make the transfer.

The by-laws almost always specify the time and place of an annual meeting of stockholders for the transaction of important business. Special meetings may be called from time to time on request of a certain number of stockholders or in whatever manner the by-laws may lay down. The important point is that to make a special meeting legal every stockholder must have proper notice in writing mailed to his last-known address. Meetings of the directors also are usually required at stated intervals and it is set forth in the by-laws that the directors are to elect the officers of the company and otherwise to manage its affairs.

The essential officers of a corporation are the president, the secretary and the treasurer. The duties of each officer should be and usually are clearly specified in the by-laws. Ordinarily the president, briefly stated, is the chief executive officer; the secretary keeps the

records of the corporation; the treasurer handles the corporate funds. The reader should clearly understand, however, that this definition of duties is not necessarily or universally followed. The by-laws may make the president the custodian of funds and the treasurer the chief executive officer, or may distribute the duties in any other manner. The law recognizes, however, that an outsider has the right to assume that the man who is given the title of president, treasurer or secretary is given the powers and duties that customarily belong to that position.

The by-laws usually declare that dividends shall be paid only out of surplus, not out of the capital of the corporation, although this is simply a formal statement of a principle which could not legally be violated in any case so long as the corporation has creditors. A corporate seal is usually adopted and briefly described in the by-laws. The procedure and necessary percentage of favorable votes in order to amend the by-laws are usually stated.

The board of directors or the stockholders may sometimes adopt new rules of action which will be binding until rescinded, without the formality of amending the by-laws, simply by passing a formal resolution. No resolution, it need scarcely be said, will be legally binding if it is contrary to any by-law provision. Resolutions are frequently used, however, to supplement and further elucidate the by-laws and to lay down a general permanent policy.

We have now covered very briefly the main points that the reader should bear in mind as to the legal status of the corporation and as to the instruments that confer and define that status. All this is rather dry and more or less technical matter; yet it must not be slurred

over by anyone who desires to acquire that knowledge of the corporate form and understanding of its uses and misuses that is essential to every person successfully concerned with modern business. We cannot afford to forget that the corporation is created and maintained under certain specific provisions of the law to which all its actions must conform.

CHAPTER III

INTERIOR ORGANIZATION

24. *Rights of stockholders.*—In this chapter we shall treat as briefly as the subject will permit the relations to each other of the various groups of individuals who are interested in a corporation. Those groups are:

I. Stockholders.
II. Creditors.
III. Directors.
IV. Officers.

Every corporation must be so organized that the duties, the liabilities and the rights of each of these groups are clearly known and may be enforced.

The nature of stock—the fact that it is an intangible share in the corporation's assets and earnings—has already been discussed. Each owner of stock becomes to the extent of his holdings an owner of the corporation. His rights fundamentally are the same as the rights of other owners of private property, but the full exercise of these rights is under the corporate form much abridged and modified. To illustrate, the private owner of a piece of property has the right to sell or destroy or give away or use for his personal enjoyment the property and its earnings. A stockholder, however, cannot sell or destroy or otherwise tamper with his proportion of the corporation's assets, because under the corporate form he has committed those assets to the care of other people.

The rights of stockholders as a body are:

(1) To elect directors.

(2) To amend the charter or by-laws.

(3) To sanction or veto the selling or mortgaging of the permanent assets of the corporation.

(4) To dissolve the company.

The first two rights have been touched upon in the preceding chapter and need not be further considered. The third right is not universal in all states and under all charters, but is generally conceded. In some states the courts assume that the stockholders, having chosen directors, freely turn over to them the sole and complete management of the business without any reservations whatsoever. Even in such states, however, the directors, in order to avoid any charge of fraud that might be brought against them, generally prefer on such important actions as the sale of permanent assets to have the officially expressed concurrence of the stockholders. A clause is sometimes placed either in the charter or in the by-laws requiring unanimous consent or the consent of a very large percentage of the stockholders in order to validate a sale or mortgage of permanent assets. The right of dissolution is very seldom exercised inasmuch as an unsuccessful corporation may be very easily abandoned and its charter allowed to lapse by non-payment of taxes.

25. *The proxy and its uses.*—The rights of each individual stockholder are four in number, as follows:

(1) To receive notice of and to participate in all stockholders' meetings.

(2) To share in the assets of the corporation in proportion to his stockholdings in case of dissolution.

(3) To share in dividends declared by the directors in proportion to his stockholdings.

(4) To inspect the accounts of the corporation.

The first right has already been mentioned. It should be further observed, however, that a stockholder's right to participate in meetings is not confined to personal attendance at the meetings. If he does not go himself he may confer the right to represent him upon some other person. The instrument which confers this right is known as a "proxy" and generally reads somewhat as follows:

KNOW ALL MEN BY THESE PRESENTS, that I, the undersigned, do hereby constitute and appoint John Doe my true and legal attorney to represent me at all meetings of the stockholders of the Blank Company and for me and in my name and stead to vote throughout upon the stock standing in my name on the books of said company at the times of said meetings, and I hereby grant my said attorney all the powers that I should possess if personally present.

This is a form well adapted to conferring a simple, unlimited right to represent the stockholder who gives it. The proxy may be much more formal and may contain any limitations that the giver chooses to impose; for instance, it may be good only for one meeting or up to a certain time or for a certain purpose, such as giving an affirmative vote on a proposition that is to come before the meeting.

The use of proxies in this country is widespread and is an important feature of corporation management. In England stockholders are more likely to appear in person at the annual meetings. By means of proxies American corporation officials are accustomed to hold meetings with no one but themselves actually attending, but with a constructive attendance through their proxies of more than a majority of the outstanding stock. The

Union Pacific Railroad, for instance, which is incorporated in Utah and must hold its annual meetings in that state, whereas its principal office is in New York City, every year sends its secretary and a few minor officials from New York to Salt Lake City, each official carrying a satchel full of proxies. The annual meeting is then held and the election of directors carried out with all the formality that would characterize a fully attended meeting. Any lone stockholder who appears in person will find that his presence adds nothing to the effectiveness of the proceedings and does not change their character in the least. Of course, in smaller companies the stockholders are more likely to be present in person, although even there representation by proxy is the established custom.

One point about a proxy that should be impressed on the mind of every stockholder is that it is never under any circumstances irrevocable. The courts will not recognize an irrevocable proxy as a valid agreement. No matter what the wording of the original proxy may be, no matter if it clearly and emphatically states that it is irrevocable, a stockholder may, as a matter of fact and of law, revoke it at his will.

The second right, as has already been intimated, is infrequently of much practical importance.

26. *The right to dividends.*—The third right—to share in dividends—is so often misunderstood by stockholders that its limitations need to be carefully noted. In the first place, notice that nothing is said as to earnings. A corporation may be getting enormous yearly profits and yet an individual stockholder may not draw any dividends whatever; nor can the stockholder get at these earnings until dividends are declared. In the second place, it will be pointed out in connection with the

powers of directors that directors alone have the right to declare dividends and cannot be compelled by any legal action whatever to grant dividends to the stockholders until they see fit. A case in point, which attracted some attention several years ago, was that of the Midvale Steel Company, a fairly large and now prosperous company, located in a suburb of Philadelphia. The management of the company for the ten years 1887 to 1897 devoted all of its earnings to improvement of the plant, in spite of protests and strenuous efforts on the part of minority stockholders to force the declaration of dividends. The courts will not interfere with the policy of the board of directors in this regard unless fraud or mismanagement can be proved.

27. *The right to information.*—The fourth right—to inspect the corporate books and accounts—was originally universally admitted and was of considerable importance. Each stockholder could go into the company's office whenever he chose and demand that he be given access to all the books and accounts. Early in the history of business corporations, however, it became evident that the manager of a rival business could buy a single share of stock and thereby obtain trade information that could be used to the detriment of the corporation. Thus the anomaly was presented of a stockholder of a corporation being able to work against the corporation's interests. The courts, recognizing the situation, have greatly modified and almost nullified this original right. No stockholder can now on legal grounds demand that he be furnished with information as to the customers of the corporation, the persons from whom supplies are bought and their prices, the corporation's contracts, and other points of similar nature. In most states he gets all the information that rightfully belongs to him if he

obtains simply a summary of the profit and loss account for the preceding year and of the balance sheet at the end of the corporation's fiscal year. Indeed, he cannot in all states secure even this meagre and apparently innocuous information.

The movement in favor of publicity of corporate accounts, however, is now so general and strong, and the force of public opinion behind it is so great, that almost all the important corporations voluntarily give to their stockholders and to the public fairly complete annual reports. Railroads particularly under the Interstate Commerce Act, as amended in 1906, are compelled to render to the Interstate Commerce Commission and through the Commission to the public and to their stockholders, a very complete and detailed summary of their operations each year. One striking exception among the large corporations to this general tendency toward increased publicity is the Standard Oil Company, whose management has never yet given out anything more than a bare statement of the amount of the capitalization and of the dividends declared. Publicity of accounts is not to be confused with the right of the individual stockholder to have access to the corporation's books, for even the greatest degree of publicity extends only to general financial results of the corporation's activities, not to the corporation's individual purchases, sales and contracts. The right to actual inspection of the books, with few unimportant exceptions, is entirely a theoretical, not a practically important, attribute of stockholders.

28. *Liabilities of stockholders.*—The next topic to consider is that of liabilities of stockholders, which may be grouped under the following four heads:

(1) Their liability to the corporation or to unsatisfied

creditors of the corporation for unpaid installments on part-paid stock.

(2) Their liability to unsatisfied creditors of the corporation in case dividends have been paid out of capital assets.

(3) In New York State, their liability to employees and servants for wages due by the corporation.

(4) In the state of Minnesota, their liability (except manufacturing corporations) to corporate creditors up to an amount equal to the face value of their stockholdings. In national banks the same rule holds good.

(5) In California the unlimited liability of each stockholder for his proportion of unpaid obligations incurred while he remained a stockholder of record. This liability continues even though he sells his stock.

With further reference to the liability first stated in the preceding paragraph, it should be observed that corporations frequently do not need at the beginning of their existence all the capital assets that will later be necessary. They therefore ask their stockholders to pay only a certain percentage of their stock subscriptions at the beginning and either set certain dates for the remaining payments or leave the dates to be fixed later by the directors of the company. In the latter case it sometimes happens that the corporation becomes so prosperous that the unpaid installments are not called for and in the course of years stockholders may almost forget that they are still unpaid. Then if the corporation later gets into financial difficulties, the owners of stock at the time may suddenly find themselves confronted by a demand for the immediate payment of unpaid installments. It is a very unpleasant and not especially uncommon situation. Buyers of stock should

therefore be very certain that their certificates are marked "full paid and non-assessable," or else make sure that they can meet whatever installments are unpaid, when called for, without great inconvenience to themselves.

The payment of dividends out of capital instead of out of earnings is a practice which we shall have occasion to refer to later in this volume. All that need be said about it here is that it might obviously be used as a means of diverting to stockholders assets pledged to creditors of the corporation and for that reason is not permissible.

29. *Rights of creditors.*—The creditors of a corporation are of two distinct kinds, secured and unsecured. The secured creditors are those who have had set aside for them under some form of agreement certain parts of the property of the corporation which are to be devoted, in case the corporation fails at the specified time to meet its debt, to paying the creditor in full. The exact procedure will be discussed at some length in connection with corporate notes and bonds. The unsecured creditors hold simply a claim against the general unattached assets of the corporation.

Whether the creditors be secured or unsecured, they have no part in the organization or management of the corporation so long as the debts to them are fully and promptly met. Only in case of insolvency or bankruptcy may they step in and exercise any rights which may have been conditionally granted to them. We will therefore defer a study of their place in the corporate organization until we come to the subjects of insolvency, bankruptcy and reorganization.

30. *"Dummy" directors.*—The statutes of nearly all the states require that the directors of a corporation

shall also be stockholders. In most states the ownership of a single share is sufficient to meet this requirement. As an example of the striking difference at times between what the law intends and what it accomplishes, this requirement deserves special mention. Obviously it is intended to prevent any one man from "packing" the board of directors; in practice it serves to facilitate the creation of and control over "dummy" directors.

A dummy director is one who serves the interest of some other person and who votes as he is told. Sometimes he is an actual stockholder or is given stock outright in order to qualify him for his position, and the man who controls him depends on influences outside the corporation to retain his control. When any doubt exists as to that point, however, the "dummy" director usually receives a certificate of stock duly transferred to him on the books of the company—which thus qualifies him to act as director—but is required to endorse the certificate back to the real owner. Thus the owner of the stock always has a string tied to the "dummy" director. If his orders are not followed to his satisfaction, all that he needs to do is to send in the certificate, have the stock transferred back to himself and thereby disqualify the "dummy." Thus a majority stockholder may elect a whole board of directors who are absolutely subservient to his orders and represent only his interests. He may not himself be a member of the board at all, and yet may dictate its every action.

31. *Powers and liabilities of directors.*—In theory, however, even if not in practice, a board of directors is supposed to represent all the stockholders equally. Partly for that reason the board, as has already been

indicated, is given complete control over the corporation's assets and officers. Very seldom, indeed, will the courts restrain the directors from taking any action short of selling or mortgaging the corporation's permanent assets, unless fraud or wrongdoing is conclusively shown. Their powers are usually more or less modified, however, by the corporation's by-laws, and, like other officers, they are not at liberty to transgress or omit any of the duties specifically set forth in the by-laws. As a general thing they have power among other things to fill vacancies in their own number until the next annual meeting of the stockholders for the election of directors, to appoint and remove officers of the corporation, and under limitations to modify or enact by-laws.

Any or all of these powers the board of directors may delegate, if they see fit, to a standing committee chosen from their number. Where the board of directors is so large as to be unwieldy and difficult to assemble at regular intervals, such delegation of powers is customary. The board of directors of the United States Steel Corporation, for example, which consists of twenty-four members, delegates a large part of its functions to a standing committee of eight members known as the finance committee. The finance committee holds frequent meetings and conferences with the chairman of the board of directors, and between meetings of the full board has complete authority to settle most questions. It also handles with full authority such financial questions as in most corporations would be referred to the board of directors. The committee with these functions in most corporations is called the executive committee.

The usual duties of corporation officers have already been treated in the preceding chapter. One officer not

mentioned there, who is in several large corporations of much importance, is the chairman of the board of directors. In the United States Steel Corporation, the New York Central Railroad Company, the National City Bank of New York, and other companies of like magnitude, the chairman of the board of directors is a prominent officer to whom the president of the corporation sometimes reports. It would not be far from wrong to say that the chairman represents the board of directors and the standing committees of the board in the intervals between meetings. To him, in other words, are delegated *ad interim* many of the powers of the board.

Personal liabilities of directors may arise in four ways:

(1) By reason of neglect or wrongdoing on their part that results in loss to the company.

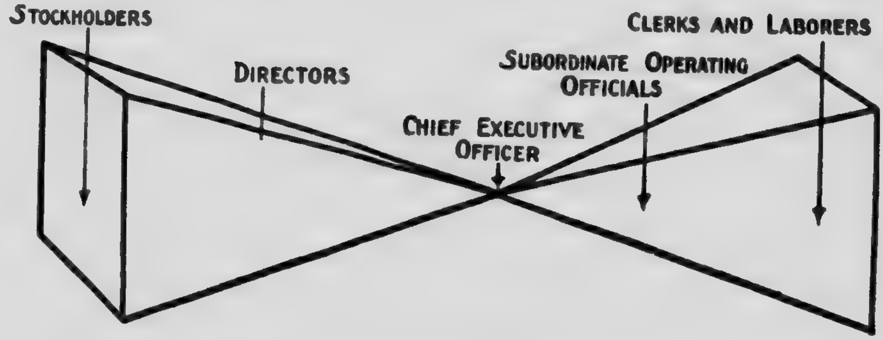
(2) By issuing stock as full paid that is not actually full paid.

(3) By paying dividends out of capital.

(4) By doing other acts specifically forbidden by the statutes of the state in which the company is incorporated.

These acts, it should be observed, in the eyes of the law are wrong and fraudulent. So long as the directors keep within the law, no liability will attach to them in their capacity of directors.

32. *The efficiency of corporate organization.*—The reader may now see more clearly perhaps why "centralization of control" was named in the first chapter as one of the important advantages of corporations. He may carry away a more vivid idea of the whole arrangement if he compares the corporation to a double pyramid, as shown in this diagram:



The base of one pyramid represents the body of stockholders or owners of the corporation who delegate their rights as owners to the directors, who in turn transfer all active authority to the president or other chief executive officer, who is at the apex of that pyramid. The other pyramid represents the subordinate officials and employees of the corporation. The chief executive officer is also the apex of this pyramid and transmits his orders through the various grades of subordinates to the clerks and laborers at the base of the pyramid. Thus responsibility and authority conferred by the stockholders and exercised over the employees are both centered in this chief executive officer. It is an organization almost ideally adapted, so far as efficiency and economy go, to the conditions of present-day industry.

CHAPTER IV

WHERE AND HOW TO INCORPORATE

33. *A corporation may be chartered in any state and do business in other states.*—The reader is probably well aware that a corporation need not necessarily take out a charter in the state in which it transacts its principal business. In fact, the great majority of the large industrial and railroad companies are incorporated in one state and carry on their operations in several states; in many cases none of their permanent assets worth mentioning are located in the state of incorporation.

This anomalous condition is made possible by the peculiar character of our American political system. Each state has the right to create corporations and by custom such corporations are recognized and allowed the usual rights and privileges in all other states. It should be noted at this point that such rights and privileges are granted as a matter of custom and of policy, or of "comity," to use the legal term, and not—as is sometimes stated even in legal text-books—under that clause of the Constitution of the United States which says that "the citizens of each state shall be entitled to all privileges and immunities of citizens in the several states." A corporation is not a citizen, but an artificial person created by law, which is an entirely different thing.

In an early case before the Supreme Court of the United States, The Bank of Augusta vs. Earle, the right of a corporation to make a contract outside the

state of its incorporation was brought into question. The decision of the Court upheld this right as a legal presumption, but stated that the right might be withdrawn by any state legislature. The opinion written by Chief Justice Taney is so important and informing that some of the salient paragraphs are quoted below:

It is very true that a corporation can have no legal existence out of the boundaries of the sovereignty by which it is created. It exists only in contemplation of law, and by force of law; and where that law ceases to operate, and is no longer obligatory, the corporation can have no existence. It must dwell in the place of its creation and cannot migrate to another sovereignty. But although it must live and have its being in that state alone, yet it does not by any means follow that its existence there will not be recognized in other places; and its residence in one state creates no insuperable objection to its power of contracting in another. It is indeed a mere artificial being, invisible and intangible; yet it is a person, for certain purposes in contemplation of law, and has been recognized as such by the decisions of this court. . . . Now, natural persons, through the intervention of agents, are continually making contracts in countries in which they do not reside; and where they are not personally present when the contract is made; and nobody has ever doubted the validity of these agreements. And what greater objection can there be to the capacity of an artificial person, by its agents, to make a contract within the scope of its limited powers, in a sovereignty in which it does not reside; provided such contracts are permitted to be made by them by the laws of the place?

The corporation must no doubt show that the law of its creation gave it authority to make such contracts, through such agents. Yet, as in the case of a natural person, it is not necessary that it should actually exist in the sovereignty in which the contract is made. It is sufficient that its existence as an artificial person, in the state of its creation, is acknowledged and recognized by the law of the nation where the dealing takes place;

> and that it is permitted by the laws of that place to exercise there the powers with which it is endowed.
>
> It is nothing more than the admission of the existence of an artificial person created by the law of another state, and clothed with the power of making certain contracts. It is but the usual comity of recognizing the law of another state.
>
> We think it is well settled, that by the law of comity among nations, a corporation created by one sovereignty is permitted to make contracts in another, and to sue in its courts; and that the same law of comity prevails among the several sovereignties of this Union. The public and well-known and long-continued usages of trade; the general acquiescence of the states; the particular legislation of some of them, as well as the legislation of Congress; all concur in proving the truth of this proposition.

34. *The regulation of "foreign" corporations.*—In the state in which its charter is granted a corporation is called "domestic"; in other states it is a "foreign" corporation. This word "foreign" must not be taken to refer to corporations of other countries than the United States; such corporations are known as "alien."

Every state in the Union regulates to a greater or less degree the business carried on within its borders by foreign corporations. In some states it is necessary to procure a license, which may be obtained by depositing with some official a certified copy of the corporation's charter and naming some agent on whom legal papers may be served. In other states it is merely required that the foreign corporation shall maintain an office and have an agent within the state. Some states restrict the power of foreign corporations to hold real estate. These regulations are not intended to apply to corporations which merely solicit orders or execute contracts incidental to their main business, but to those which are permanently established.

35. *Choosing the state of incorporation.*—Unless there is some reason to the contrary, it is generally much better for a corporation to get its charter in the state in which its principal business is located. This remark applies particularly to small companies operating wholly within one state. There are several reasons therefor. One is the fact that a foreign corporation must usually pay incorporation and annual franchise taxes in the state of incorporation and in addition a license fee or some other kind of a tax in the state in which it does business. Another reason is that the courts of each state are inclined to treat domestic corporations with greater consideration than foreign corporations. A third reason is that there is a popular prejudice, more or less well-founded, against those companies which go to other states for their charter. Creditors and prospective buyers of the corporation's securities are apt to ask embarrassing questions as to why the corporation cannot or does not comply with the legal requirements of its own state. A fourth reason is the inconvenience caused by the necessity of filing reports and generally of maintaining a separate office in the state of incorporation. If the managers of a small local concern, therefore, are considering where to incorporate, the answer will almost always be, "Get your charter in the state where you expect to do most of your business."

The answer to a similar question is not so easy, however, where the prospective corporation will be large, or where its business will be widely scattered through many states, or where its managers have in view some purpose or purposes not favored by the laws of the state in which its principal office is to be located. Neither is the answer so easy even for small local con-

cerns in those ultra-conservative states in which the corporation laws are unduly burdensome or corporation taxes unduly expensive. Under all these circumstances, persons who are about to form a new corporation, or who are thinking of giving up their charter in one state, will naturally look about and compare the advantages obtainable under the laws of the various states. There are great variations among the states in regard to taxes, liberality of corporation laws and treatment of foreign corporations, and the problem of weighing all these factors and picking out the most economical and advantageous corporate home is often very difficult. The advice of a thoroughly competent corporation lawyer in all such cases is absolutely essential. Nevertheless, for his own protection, both in forming and in dealing with corporations, every business man should have a pretty accurate idea of the requirements and privileges in all the important states.

36. *Comparative charges in several states.*—The first and most obvious factor to consider in selecting the state of incorporation is the cost. This cost consists of organization fees, annual taxes and counsel fees. The following tables copied from a convenient manual by Thomas Conyngton, of the New York Bar, entitled "Corporate Organization," will give the reader an idea of how these expenses run in the five states which are most commonly used for incorporation by companies that expect to do business in other states:

COMPARATIVE TABLE OF ORGANIZATION EXPENSES.

(Including all Filing and Incidental Fees.)

Capital Stock of Company.	*New Jersey.*	*New York.*	*Delaware.*	*Maine.*	*South Dakota.*
$1,000	$35.00	$16.00	$25.00	$27.00	$13.00
5,000	35.00	17.50	25.00	27.00	13.00
10,000	35.00	20.00	25.00	27.00	13.00

Capital Stock of Company.	New Jersey.	New York.	Delaware.	Maine.	South Dakota.
25,000	35.00	27.50	25.00	67.00	13.00
50,000	35.00	40.00	25.00	67.00	18.00
100,000	35.00	65.00	25.00	67.00	18.00
500,000	110.00	265.00	65.00	67.00	23.00
1,000,000	210.00	515.00	115.00	117.00	33.00
5,000,000	1,010.00	2,515.00	365.00	517.00	113.00
10,000,000	2,010.00	5,015.00	615.00	1,017.00	133.00

COMPARATIVE TABLE OF ANNUAL FRANCHISE TAXES.

$1,000	$1.00	$1.50	$5.00	$5.00	None
5,000	5.00	7.50	5.00	5.00	"
10,000	10.00	15.00	5.00	5.00	"
25,000	25.00	37.50	5.00	5.00	"
50,000	50.00	75.00	10.00	5.00	"
100,000	100.00	150.00	10.00	10.00	"
500,000	500.00	750.00	25.00	50.00	"
1,000,000	1,000.00	1,500.00	50.00	75.00	"
5,000,000	4,000.00	7,500.00	150.00	275.00	"
10,000,000	4,250.00	15,000.00	275.00	525.00	"

South Dakota and Delaware are fair examples of what are sometimes called the "bargain counter" states, so far as incorporation expenses are concerned. Arizona also belongs in this class, and West Virginia and the District of Columbia might until recently have been included. As an example of the importance of this feature when large companies are formed, it has been estimated that if the United States Steel Corporation had taken out its charter in Pennsylvania, where most of its business is transacted, the organization expenses would have been about $3,500,000, whereas in New Jersey, where the charter was actually obtained, the corresponding expenses were only about $220,000. A great many companies which are organized to exploit mines or new inventions or other highly speculative enterprises may without impropriety issue very large amounts of stock, although the actual market value of their assets at the time of incorporation may be very

small; in such cases it is customary and obviously economical to secure a "bargain counter" charter.

In those states where taxes and initial fees are small the necessary expense for legal assistance is apt to be at a minimum, for two reasons: first, because the state legislatures obviously are making a bid for the cheap incorporation business and will naturally make their forms and the necessary red tape of incorporation as simple as possible; second, because in such states incorporation agencies which carry on their business on a wholesale scale, are in existence, and high-priced legal talent is hardly necessary. In other states competent attorneys should always be secured, and their fees may be expected to range from $50 up. In this connection it may be well to remark also that the necessary corporate records, which are the secretary's minute book, the stock certificate book and the stockholders' register, may be obtained for from $10 to $500 per set. One of the cheaper sets is all that is necessary for most small companies. The reader now has sufficient data before him to form a rough estimate of the expense necessarily involved in the process of incorporation.

This factor of initial cost, however, in the case of companies which expect permanently to carry on an established business is, after all, a minor consideration. Among the other important points to bear in mind in selecting a corporate domicile, four stand out most prominently—the liberality of the laws, the permanence of the laws, the liabilities attaching to stockholders and the reputation of the state.

37. *Liberality of corporation laws in several states.*—The chief respect in which state laws differ, so far as liberality is concerned, is in granting or denying the right to buy and sell the securities of other corporations.

In 1889 New Jersey, first of all the states, enacted that corporations formed under its laws might hold the stock of other corporations. This privilege proved of great importance in the financial and industrial development of this country. The New Jersey act in this respect was followed by Delaware, Maine and New York. In 1913, however, through the so-called "Seven Sisters Law," New Jersey attempted to define and make illegal and criminal all monopolies and agreements to discriminate, prevent competition, limit production and fix prices. The great industrial trusts, which formerly patronized this state when incorporating new companies, are now obliged to look elsewhere.

Another feature in which the various states differ widely with regard to liberality is the issuance of stock for property. Most corporations as now organized turn over at least part of their stock in exchange for property, not cash. Some of the states make the estimate placed by the directors upon the value of the property so secured conclusive unless fraud is clearly shown. Other states hedge this general principle about with irritating and usually unnecessary restrictions. Liberality of the state laws as to other less important points will be considered by careful incorporators, but are too technical to be discussed here.

38. *Permanence of the laws.*—In those states in which the general corporation statutes have existed for some years practically unchanged, it is reasonable to expect that they are in fairly permanent form. Moreover, in such states the courts have given a large number of decisions on vital points. Both the statutory law and the interpretation of that law, therefore, may be considered well settled. This is a matter of prime importance to large corporations, which may expect, from the

very extent of their business, to be involved in more or less litigation. They want to know where they stand at all times and do not care to be confronted with sudden legislative enactments or with unexpected court decisions. For this reason the large corporations which had incorporated in New Jersey were especially hard hit when the "Seven Sisters Amendments" were suddenly enacted.

The liabilities imposed upon stockholders have already been treated in the preceding chapter. The states of California, New York and Minnesota, as there noted, impose certain liabilities additional to the usual liability on capital stock. These liabilities are not apt to prove a serious matter. Yet corporations generally look with some alarm at any provisions of this nature.

39. *Reputations of various states.*—The reputation of the state of incorporation may have considerable effect on the sale of corporate securities. It is so well-known, for instance, that the laws of South Dakota and Arizona are lax that investors look with distrust on any corporation which operates under one of their charters. This statement, although to a much less degree, applies to Delaware and to Maine. Delaware is now especially popular, having in part displaced New Jersey after the legislation already referred to. West Virginia and the District of Columbia do not rank nearly so well, on account of their record, although the District of Columbia law in 1905, on the recommendation of President Roosevelt, was altered and improved and the West Virginia law also has been changed. Connecticut, Massachusetts, Pennsylvania and Illinois have reasonably—Massachusetts perhaps unreasonably—strict requirements, and all as states of incorporation are in good repute. Among all the

states, New York, under its "Business Corporations Law," as amended in recent years, perhaps best combines the advantages of liberality and of high repute. Its laws, however, have not been so thoroughly tested and settled by the courts as the corresponding laws of New Jersey.

40. *Comparative summary of the advantages and disadvantages of the important states.*—For the benefit of readers who may desire to form a corporation or who may have occasion to consider the advisability of buying stock of a company incorporated in some other state than the one in which it does business we give below a brief summary of the advantages and disadvantages of several states:

ARIZONA.

Advantages:

1. Stock may be issued for money, property, or services. The fact that it can be issued for services may be an important advantage.

2. Directors' meetings may be held outside of the state.

3. The organization fee is very small. The annual franchise tax is small.

4. Cumulative voting is permitted.

Disadvantages:

1. Stockholders' meetings must be held within the state, unless at first meeting a by-law provision permitting subsequent meetings outside the state is adopted.

2. The corporation laws are not thoroughly adjudicated.

CONNECTICUT.

Many promoters do not care to incorporate in Connecticut as they imagine that the advantages are not great. As a matter of fact, the high organization fee is the chief disadvantage.

Advantages:

1. Stock may be paid for in either cash or property. The judgment of the directors is final with regard to the value of

the property for which stock is issued, except in case of fraud.

2. Incorporators may be non-resident.

3. There is no annual franchise tax.

4. Corporations may hold stock in other corporations.

Disadvantages:

1. Stockholders' meetings must be held within the state. There is no provision requiring the meetings of the directors to be held within the state, but this may be inferred.

2. There is an inheritance tax on the stock.

3. The organization fees are comparatively high, from $25 to $2,510.

DELAWARE.

Advantages:

1. Stockholders' and directors' meetings may be held outside of the state, if the by-laws so provide.

2. Stock may be issued for cash, property or services.

3. Incorporators may be non-resident.

4. Corporations may hold stock in other corporations.

5. Provision may be made whereby bondholders will be permitted to vote. This provision makes a good market for bonds because bondholders will be assured that they will have a voice in the management of the corporation.

6. Organization fees are not very large, ranging from $20 to $765, including filing fees.

Disadvantages:

1. One of the directors must live in Delaware.

2. There is an inheritance tax on stock, applying both to residents and to non-residents.

3. There is an annual franchise tax.

DISTRICT OF COLUMBIA.

Advantages:

1. Very small cost of incorporation, probably not exceeding $10.

2. No franchise or inheritance tax.

Disadvantages:

1. A majority of the trustees, (the term trustee corresponds to the term director) must live in the District.

2. Stock cannot be issued for services, only for property or cash.

3. 10 per cent of capital stock must be paid in before beginning business. New York requires 50 per cent paid in before the end of the first year, but business can be carried on in the meantime. Here, no business can be done in the name of the corporation till 10 per cent is fully paid in.

4. An annual report of the corporation must be filed and published. This report must include amount of capital stock authorized, amount paid in and amount of existing debts.

5. The corporation cannot own stock in other corporations.

6. Corporation laws are unadjudicated.

MAINE.

Advantages:

1. Stock may be issued for property, cash or services. The judgment of the directors is conclusive as to value of the property—always provided there is no evidence of fraud.

2. Incorporators and directors may be non-resident.

3. Directors' meetings may be held outside of the state.

4. The corporation may acquire stock in other corporations.

5. Low organization fees, ranging from $10 to $517 for a $5,000,000 corporation.

Disadvantages:

1. Stockholders' meetings must be held within the state.

2. There is both an inheritance and an annual franchise tax; the latter, however, is very small.

MASSACHUSETTS.

Advantages:

1. Incorporators and directors may be non-resident.

2. Directors' meetings may be held outside of the state.

3. Stock may be issued for cash, property or services.

Disadvantages:

1. Stockholders' meetings must be held within the state.

2. It is doubtful whether ordinary corporations can hold stock in other corporations.

3. A detailed annual report must be rendered to the state authorities.

4. There is an inheritance tax.

5. The organization fee varies from $25 for a $10,000 corporation to $1,200 for a $5,000,000 corporation.

NEVADA.

Advantages:

1. Incorporators and directors may be non-resident.

2. Stockholders' and directors' meetings may be held outside of the state.

3. Stock may be issued for cash, property or services. The judgment of the directors is conclusive as to value of property, providing there is no evidence of fraud.

4. Action of the majority of the stockholders or directors may be valid without regular meeting; that is, there may be an informal meeting held, without any notice whatsoever being given.

5. Bondholders may be given the right to vote.

6. Cumulative voting is allowed.

7. No annual franchise tax.

8. The organization fee is comparatively low, ranging from $15 to $700; there are no filing fees except those imposed by counties.

Disadvantages:

1. In some cases an annual report must be prepared for the state authorities.

2. The state's reputation as a corporate home is not of the best.

NEW JERSEY.

Advantages:

1. Corporations may hold stock in other non-competitive corporations. New Jersey was the first state to authorize the formation of holding companies.

2. Incorporators may be non-resident.

3. Stock may be issued for property or cash. Judgment of the directors is conclusive as to value of property. The courts, however, have shown a strong tendency to accept circumstantial evidence of fraud.

4. Directors' meetings may be held outside of the state, if by-laws so provide.

5. Cumulative voting is permitted.

6. A voting trust, under certain restrictions, may be created.

7. Laws are all well adjudicated.

Disadvantages:

1. Stockholders' meetings must be held within the state.

2. One of the directors must live in the state.

3. There is an annual franchise tax; also an inheritance tax, but this does not apply to non-residents. Fees are from $25 to $1,000; filing fee $10.

NEW YORK.

Advantages:

1. Stock may be issued for cash, property, or *labor*. Labor must be distinguished from "services" though there is no decision explaining the exact difference. The judgment of the directors is conclusive as to value of property, provided there is no evidence of fraud.

2. Directors' meetings may be held outside of the state.

3. Corporations may hold and control the stock of other corporations.

4. Cumulative voting is permitted.

5. A voting trust may be created, limited, however, to five years.

Disadvantages:

1. Stockholders' meetings must be held within the state.

2. One incorporator and one director must reside within the state.

3. One-half of the capital stock must be paid in within a year from incorporation.

4. Detailed books and accounts of the business are required.

41. *Agreements prior to incorporation.*—Sometimes a corporation is formed practically by and for an individual acting alone, who expects to take all the stock except what is necessary to qualify dummy directors and either hold it permanently or dispose of it whenever an opportunity arises later. Frequently, also, it happens that a corporation is organized to take over the business of a pre-existing partnership and the partners have come to an informal understanding as to how much stock shall be issued to each one. Under such circumstances, of course, no formal agreements previous to incorporation are necessary.

In many instances, however, corporations are formed by the harmonious action of a number of men who mutually agree as to the purposes, capitalization and other essential features of the new corporation and who each subscribe for a certain amount of stock. In such cases it is customary to draw up what is known as a "subscription contract" and to leave space at the bottom of this contract for each subscriber to write his name and fill in the number of shares that he agrees to take. The subscription contract should state among other things the par value of each share of stock, the total number of shares to be issued and the total number to be subscribed, in order to make the contract binding. Usually the subscription list is accompanied by a prospectus (described in Chapter XVI) which more fully states what the corporation is expected to accomplish. It should be noted that the subscription contract may be made immediately binding by having the amount of the subscription payable to certain specified trustees; or if not immediately binding, it will become binding as soon as the proposed corporation is properly organized and prepared to handle funds.

The remaining step in incorporation is very simple and has already been touched upon in Chapter II. It consists of drawing up a charter in proper legal form, filing it with the secretary of state or such other official as is designated by the laws of the state in which the charter is to be obtained, and receiving notice of his acceptance thereof.

42. *The wide range of choice in incorporation.*—If the reader has acquired by the reading of this chapter a clear conception of the freedom and liberality of corporation laws and of the ease with which almost any legitimate business may be put into the form of the corporation, the main purpose of the chapter will have been fulfilled. The advantages of the corporate form for almost all kinds of business were pointed out in the first chapter. One of the chief advantages named was flexibility, by which was meant the ease with which the corporate form could be adapted to small or to large enterprises.

Now we are in a position to expand still further the meaning of that word "flexibility" in connection with corporations and to say that it means also the ease with which the corporate form may be adjusted to any sort of a business need. If the incorporators cannot find in one state the authority or the cheapness that they desire, they may pick out some other state in which those qualities are prominent in the general corporation law. If the incorporators desire permanence and legal stability above all things, they may go to still another state. The range of choice is wide. It takes only a little effort and ingenuity for a capable lawyer to fit out a business enterprise with the exact corporate powers and organization that will prove most advantageous.

43. *Canada's corporation laws.*—The advantages, drawbacks and principles of the corporate form, discussed in previous pages, are in a general way applicable to Canada as well as to the United States. Here it is necessary only to examine briefly the corporation laws of the Dominion. Each of the nine provinces of Canada has its own company laws. In addition there is the Companies' Act of the Dominion, known commonly as the Federal Act. This act is divided into six parts. The first deals with joint stock companies; the second, with companies' clauses; the third, with the incorporation of loan companies; the fourth, with British loan companies; the fifth, with British and foreign mining companies; and the sixth comprises only two clauses dealing chiefly with the payment of debentures by loan companies.

The Secretary of State at Ottawa may grant charters, on certain conditions, to not less than five applicants who must file with him the following information:

(a) The proposed corporate name of the company, which shall not be that of any other known company, incorporated or unincorporated, or any name liable to be confounded therewith, or otherwise, on public grounds, objectionable.

(b) The purposes for which the incorporation is sought.

(c) The place within Canada which is to be its chief place of business.

(d) The proposed amount of its capital stock.

(e) The number of shares and the amount of each share.

(f) The names in full and the addresses and calling of each of the applicants, with special mention of the names of not more than fifteen and not less than three of their

number, who are to be the first or provisional directors of the company.

(g) The amount of stock taken by each applicant, the amount, if any, paid in upon the stock of each applicant, and the manner in which the same has been paid, and is held for the company.

Existing companies may be incorporated under this act as may also any company incorporated under any general or special act of any of the Canadian provinces, or under the laws of the United Kingdom or any foreign country. There is a tariff of fees to be paid on application for incorporation. This tariff may be varied by the government according to the nature of the company, the amount of capital stock, and the like. A company must not commence its operations or incur any liability before 10 per cent of its authorized capital has been subscribed and paid.

In order to check traffic in charters, any charter granted under the Dominion Act becomes forfeited in case of non-use by the company, or in case the company does not go into actual operation within three years after the charter is granted.

The Dominion Law particularly emphasizes that the word "Limited" must appear after the company's name. This applies to notices on the company's offices, their literature, bills of exchange, and other stationery. The liability of shareholders is limited to the amount unpaid on their respective shares in the capital stock. The question of liability being an important one, we may quote sections 39 to 42 of the Dominion Companies' Act on that point:

39. Any shareholder may plead by way of defence in whole or in part to any action by any creditor under the last preceding section of any set-off which he can set up against the

company, except a claim for unpaid dividends or a salary or allowance, as a president or a director of the company.

40. No person holding stock in the company as an executor, administrator, tutor, curator, guardian or trustee of or for any person named in the books of the company as being so represented by him, shall be personally subject to liability as a shareholder: but the estate and funds in the hands of such person shall be liable in like manner, and to the same extent as the testator or intestate would be if living, or the minor, ward, or interdicted person or the person interested in such trust fund would be, if competent to act and holding such stock in his own name.

41. No person holding such stock as collateral security shall be personally subject to such liability, but the person pledging such stock shall be considered for the purposes of such liability as holding the same and shall be liable as a shareholder accordingly.

42. Every such executor, administrator, curator, guardian or trustee shall represent the stock held by him, at all meetings of the company, and may vote as a shareholder; and every person who pledges his stock may represent the same at all such meetings, and notwithstanding such pledge, vote as a shareholder.

The capital stock of the company must be personal estate and transferable. The directors of a company may make by-laws for creating and issuing any part of the capital stock as preference stock. Several clauses of the act deal with the increase of capital.

If authorized by by-law, sanctioned by a vote of not less than two-thirds in value of the subscribed stock of the company represented at a general meeting duly called for considering the by-law, the directors may from time to time:

(a) Borrow money upon the credit of the company.
(b) Limit or increase the amount to be borrowed.

(c) Issue bonds, debentures or other securities in the company for sums not less than one hundred dollars each, and pledge or sell the same for such sums and at such prices as may be deemed expedient.

(d) Hypothecate, mortgage, or pledge the real or personal property of the company, or both, to secure any such bonds, debentures or other securities and any money borrowed for the purposes of the company.

No dividend must be declared which will impair the capital of a company. The directorate may comprise not more than fifteen and not less than three. The powers of directors are fully specified in the act, as is also the liability of directors and officers. They are prohibited from declaring and paying a dividend when the company is insolvent. They are also liable for the transfer of shares to persons who are not apparently of sufficient means to pay up fully such shares. Other matters of directorial liability are loans by companies to shareholders, wages unsatisfied and premature commencement of business.

If shareholders are dissatisfied they may have an investigation of their company's affairs. This is obtained upon the application of shareholders, representing not less than one-fourth in value of the issued capital stock of the company, to a local judge. If he deems it necessary, he may appoint a competent inspector to investigate the affairs and management of the company. The company itself may, by resolution passed at the annual meeting or at a special meeting, appoint an inspector for a similar purpose.

Canadian companies are not unduly bothered with requests for official statements. The directors must place before the shareholders annually "a full printed statement of the affairs and financial position of the com-

pany." Whenever the Secretary of State asks for a return containing the following particulars, it must be made by the company:

(a) The amount of the capital of the company and the number of shares into which it is divided.

(b) The number of shares taken from the commencement of the company up to the date of the return.

(c) The amount of calls made on each share.

(d) The total amount of calls received.

(e) The total amount of calls unpaid.

(f) The total amount of shares forfeited.

(g) The names, addresses, and occupations of the persons who have ceased to be members within the twelve months next preceding, and the number of shares held by each of them.

44. *Extra-provincial licensing acts.*—One of the serious difficulties in company incorporation matters in Canada is the operation and effect of what are known as the extra-provincial licensing acts. These are in force in the various provinces in Canada. Generally speaking, these laws require companies incorporated outside the province enacting the law, to comply with certain conditions and pay certain fees before being allowed to carry on business in the province. Default in these matters is met with penalties. In most of the Canadian provinces, these extra-provincial acts apply not only to companies incorporated under the Dominion Act, but also to those incorporated in other Canadian provinces or in foreign jurisdictions. These conditions naturally complicate the incorporation of companies in Canada and undoubtedly interfere considerably with the business, trade and commerce of the Dominion. The question as to the rights of the nine provincial and the Dominion governments in the matter of company control has been before the courts

of Canada for many years, and there seems little likelihood of an early decision between the two parties.

The formalities necessary to secure authorization under the various acts vary with the provinces. In some of the provinces, the authorization is obtained by a "license"; in others, it is secured by "registration." In all the provinces, the administration of the acts is in the hands of the government department that administers the Companies' Act, and the procedure is similar to that in issuing a charter.

As the corporation laws of Canada stand, it is unwise for company promoters to proceed with the business of promotion and incorporation without the services of reputable Canadian lawyers, and preferably those who are accustomed to the intricacies of the various acts.

An example of a Dominion charter is appended.

The forms of charter of the various provinces are somewhat similar to that of the Dominion.

AMERICAN KITCHEN PRODUCTS COMPANY OF CANADA, LIMITED

Public Notice is hereby given that under the First Part of chapter 79 of the Revised Statutes of Canada, 1906, known as "The Companies' Act," letters patent have been issued under the Seal of the Secretary of State of Canada, bearing date of the 20th day of August, 1913, incorporating William Jay Schieffelin and Henry Stevenson Livingston, merchants, and Benjamin Jonas Weil, real estate dealer, of the City of New York, in the State of New York, one of the United States of America, and David Charles Robertson, King's counsel, and Charles Lovelace Buchanan, accountant, of the City of Montreal, in the Province of Quebec, for the following purposes, viz.:—(*a*) To manufacture, purchase and sell bouillon cubes

and other kinds of concentrated food products; (*b*) To purchase, manufacture and sell any raw material used for the manufacture of such cubes or food products; (*c*) To carry on the business of merchants or of manufacturers' agents in connection with the purchase or sale of such cubes or food products; (*d*) To carry on the business of warehousemen for the warehousing of their own products or those of others; (*e*) To apply for, purchase or otherwise acquire any patent of invention or secret process useful for the purposes of any business which the company is authorized to carry on; (*f*) To sell out the undertaking of the company, in whole or in part, for such consideration as the company may deem fit, and in particular for shares, debentures or securities of any other company having objects similar, in whole or in part, to those of this company, notwithstanding the provisions of section 44 of the said Act, and to provide by by-law the manner in which the directors may be authorized to make such a sale; (*g*) To acquire the good-will, rights and property of any kind, and to acquire and undertake the whole or any part of the assets and liabilities of any person, firm, association or corporation having powers similar to those of this company, and to pay for the same in cash, stock or bonds of this corporation or otherwise; (*h*) To amalgamate with any company having powers similar to those of this company, upon such terms and conditions as may be agreed upon; (*i*) To acquire by purchase, subscription or otherwise, and to hold, sell or otherwise dispose of shares, stocks, bonds or obligations of any company having objects similar, in whole or in part, to those of this company, notwithstanding the provisions of section 44 of the said Act, and to vote thereon as owners thereof; (*j*) To invest and deal with the moneys of the company not immediately required in such manner as from time to time may be determined; (*k*) To acquire from time to time land and to erect such buildings thereon as may be thought necessary for the purposes of the company, and to lease, sell or otherwise dispose thereof. The operations of the company to be carried on throughout the Dominion of Canada and elsewhere by the

name of "American Kitchen Products Company of Canada, Limited," with a capital stock of thirty thousand dollars divided into 300 shares of one hundred dollars each, and the chief place of business of the said company to be at the City of Montreal, in the Province of Quebec.

Dated at the office of the Secretary of State of Canada, this 21st day of August, 19—.

THOMAS MULVEY,
Under-Secretary of State.

CHAPTER V

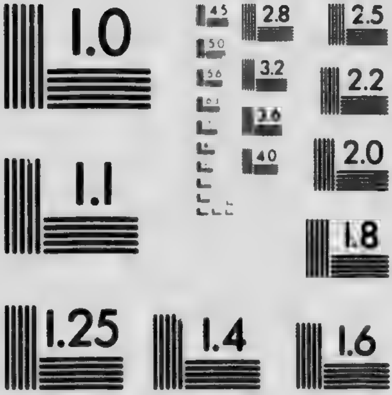
CORPORATE STOCK

45. *Stock certificates not fully negotiable.*—As has already been said, corporate stock is not a tangible thing; it is simply a right to share under certain limitations in the management, the assets and the earnings of the issuing corporation. Stock is represented by certificates, which are in possession of the owners. These certificates, however, it must not be forgotten, are merely evidence, not proof, of the ownership of stock. Actual ownership is proved by reference to the books of the company in which the names of the stockholders and the number of shares held by each one are entered. Certificates of stock are not, therefore, strictly speaking, negotiable instruments, but quasi-negotiable—a term which the reader will find defined in the volume on COMMERCIAL LAW.

The question as to whether stock certificates ought to be made negotiable or not has been much agitated, especially among lawyers. A committee of the Commission on Uniform State Laws, which is a body of lawyers appointed by the governors of forty-one states, issued a report in March, 1909, strongly advocating amendments to existing laws which would make transfer of ownership of corporate stock complete on delivery of endorsed certificates of stock without waiting for the formal transfer on the books of the corporation; in other words, the proposed amendments would make certificates of stock true negotiable instruments. The

MICROCOPY RESOLUTION TEST CHART

(ANSI and ISO TEST CHART No. 2)



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important sections of the text of the proposed amendments are as follows:

SECTION 1. Title to a certificate and to the shares represented thereby may be transferred:

(a) By the delivery of the certificate, if indorsed either in blank or to a specified person, signed by the person appearing by the certificate to be the owner of the shares represented thereby.

(b) By delivery of the certificate with a written assignment thereon, or a power of attorney to sell, assign, or transfer the certificate of the shares represented thereby signed by the person appearing by the certificate to be the owner of the shares represented thereby. Such assignment or power of attorney may be either in blank or to a specified person.

The provisions of this section shall be applicable although the charter or articles of incorporation or code of regulations or by-laws of the corporation issuing the certificate and the certificate itself provide that the shares represented thereby shall be transferable only on the books of the corporation or shall be registered by a registrar or transferred by a transfer agent.

SECTION 17. Nothing in this act shall be construed as forbidding a corporation to treat as owner in every way the person who may be registered on its books as the owner of shares.

In an editorial in *The Journal of Accountancy,* the writer said as to this proposed amendment:

Accountants, as well as lawyers and business men, have a direct interest in this proposition. If it is adopted by the states in which numerous corporate charters are granted, the effects will be felt in many different forms. Indeed, it is doubtful, judging from their explanatory notes, whether the commissioners realize what an extensive reform they are proposing. At first glance, to be sure, it does not appear that any considerable revision of present practice is intended; yet the act plainly points toward passing the rights and privileges of stockholders along with transfers of stock certificates.

The change would no doubt f. ilitate somewhat the purchase

and sale of stock by removing the technical requirement that transfers must be made on the books of the corporation. It would enable the stock exchange brokers to carry on their business more easily and more smoothly. It would make stock certificates more acceptable to banks as collateral for loans. These are the strongest arguments in favor of the act.

On the other side of the question, it should be remarked that making certificates of stock fully negotiable subjects them to increased danger of forgery, theft and loss. Many people, no doubt, would prefer the comparative safety of the present system, just as many investors, when a choice is offered, take registered rather than coupon bonds. This is a point of considerable importance. A far stronger argument against the proposed measure, however, is that it would destroy the value of a corporation's record of its stockholders and would thereby foster fraud. Accountants are only too familiar with cases in which corporations are organized simply for the purposes of transferring property from one hand to another in such a manner as to conceal profits or to swindle creditors. Under the present arrangement it is generally possible, if fraud is suspected, to get access to the stockholders' ledger and to learn who are the owners of the corporation. If a connection between the former owners of the transferred property and the stockholders of the corporation can be proven, a case of fraud may be made out. Under the proposed arrangement it would be impossible to discover the true owners of such a corporation. The stockholders' ledger, indeed, might be kept, but it would be of small value. The certificates of stock, and consequently the ownership of the corporation, might change hands a half dozen times without appearing on the corporation's books. Numerous similar cases will occur to any accountant.

We do not wish to go on record as absolutely opposed to this act. We have no doubt that it would be a convenience to corporation officials, bankers and business men generally if stock certificates were made fully negotiable. We would emphasize the fact, however, that this provision would also prove a great convenience where fraud or manipulation is intended. It would

make secrecy as to corporate ownership even easier than it is now and would tend to lessen the responsibility that ought to attach to the stockholders of corporations. We think these evils important enough to outweigh the advantages that have been named. For that reason we suggest that the law with regard to transfers of stock ought to be left unchanged until further provision has been made for pubicity of corporate accounts and for detection and punishment of the frauds which the corporate form already too much favors.[1]

46. ***Par vs. market value of stock.***—Each share of stock in practically every case has a nominal money value. The most common nominal value of each share is $100; other nominal values commonly used are $50, $25, $10 and $1. This nominal money value of each share is sometimes called the "par value." To the uninitiated the par value of stock often seems quite an important matter. They are apt to regard it as being of much the same character as the face value, say, of a promissory note. A little reflection, however, will readily convince anyone that there is no close analogy between the par value of a share of stock and the face value of a note, and that the par value of a share throws very little light on the actual value of that share.

To make this proposition clear, let us suppose that three oil wells are discovered by three different individuals, the three wells being practically identical in location, quality of oil produced, amount of flow, permanence, cost of operation, access to markets, and other essential attributes. Each of the owners, we will say, interests some friends and outsiders and organizes a corporation to work his well. One owner is extremely conservative and therefore has his corporation issue only 1000 shares of a par value of $1 per share; the second

[1] *The Journal of Accountancy*, March, 1909.

owner, being somewhat more sanguine, thinks his well is worth more and, therefore, has his corporation issue 1000 shares, each of a par value of $10; the third owner is blessed with a vivid imagination which leads him to have his corporation issue 1000 shares, each of a par value of $100. Now what will be the actual value of a single share in each of these companies? Obviously each share entitles the owner to one one-thousandth of the assets and earnings of the well. As the wells, according to our supposition, are equally profitable, there will be no difference whatever between the three shares so far as their actual values are concerned.

Any number of further examples, drawn from experience, might be given to illustrate this truth. In fact, a simple inspection of the prices for stock bought and sold on the various stock exchanges of the country is sufficiently convincing. Most of the shares of stock there traded in have par values of $100; their market values will be found to range between next to nothing and $600 or $700—sometimes even more for bank stock.

The fact, then, that a certain share of stock has a nominal value is of small importance. Its practically valuable attribute is its right to a certain share in the corporation's assets and earnings. How much is that share to be? That question may be answered simply by knowing how many shares of stock are outstanding. If a corporation's assets are worth $1,000,000 and there are 1000 shares in the hands of stockholders, we know at once that the true value of each share is $1000 without reference to its par value.

This leads us to a question which was brought up several years ago by a prominent corporation lawyer and has been much discussed. Why not eliminate these useless par values and make each share in form as it is

Countersigned this ...... day of .... 19....
by .... Transfer Agent

THE CORPORATION FINANCE COMPANY

Capital Stock $1,000,000

This certifies that .... is the owner of .... Shares of the full paid Capital Stock of the CORPORATION FINANCE COMPANY, transferable only on the books of the Company, in person or by Attorney, on surrender of this Certificate.

New York City, ..., 19....

.... *Secretary.* .... *President.*

Shares $100 Each.

[On stub.]

No. ....

.... Shares

.... 19....

Issued to

....

....

Received above described Certificate,

.... 19....

....

[On back.]

FOR VALUE RECEIVED, ... hereby sell, assign and transfer unto ....
.... Shares of the Capital Stock represented by the within Certificate, and do hereby irrevocably constitute and appoint .... Attorney to transfer the said Stock on the Books of the within named Company, with full power of substitution in the premises.

Dated .... 19....

....

In presence of ....

Registered this .... day of .... 19....
City Trust Company of New York,
by .... Secretary.

in practice simply a right to a certain percentage of the assets and earnings of the issuing corporation? The form of a certificate of stock under the present system is given on page 70. The question before us is whether it would not be better to make the second line of the face of the certificate read instead of "Capital Stock $1,000,-000," "Number of shares 10,000," and to eliminate the last line, "Shares $100 each," altogether. Logically there could be no objection to the proposal; each share would be just as valuable—no more and no less—after the change as before. The chief advantage gained would be that misconceptions based on the idea that par value and actual value in some way correspond would no longer be possible.

Although this reform would be desirable, and is now legally permissible in New York and in some other states, it is not very seriously advocated and probably will never be adopted simply because the custom of assigning a nominal money value to each share has become well established and would be very difficult to eradicate. The same object will be attained in time, as people become more familiar with corporation practice, by the general recognition of the obvious fact that par value and actual value need not correspond; that the earning power of each share is the real test of value.

47. *Nature of preferred stock.*—In most corporations all the stock is of one class and each share has an equal right to its proportion of the assets and earnings. Such stock is called "common" because no share has any privileges which do not attach to all the other shares. In general, common stock may be defined as stock which does not possess any special or peculiar rights.

Other corporations, however, set aside certain amounts of stock in a separate class and grant to this class spe-

cific privileges. Such stock is called preferred. The usual preference consists in giving a fixed dividend to the stock preferred before any payment whatever is made to the common stock. This dividend may be "cumulative"; that is, if profits are not enough to pay it in full in one or more years, the unpaid portion remains as a claim against earnings that must be settled before any payment is made to the common stock. Or it may be "non-cumulative"; that is, if profits in any year, including usually the accumulated profits of preceding years, are insufficient to cover the preferred stock dividend, the unpaid portion is wholly lost to the preferred stockholders, no matter how large the earnings in succeeding years may be. Let it be kept clearly in mind, however, that preference as to dividends is merely the usual, not the universal, privilege given to preferred stock. When the single statement that stock is "preferred" is made, it is necessary to consult the charter and by-laws of the corporation in order to be sure as to the exact nature of the preference.

The stock may be preferred as to assets, as well as dividends, or as to both. Furthermore, cumulative preferred stock may get a fixed dividend, and no more, which is the customary arrangement; it may get a fixed dividend and then, after the common stock has secured a fixed dividend, all the rest of the earnings may be divided equally between the two stocks, which is the arrangement presumed by law unless an expressed stipulation to the contrary is contained in either the charter or by-laws; or it may get a fixed dividend and the common stock a fixed dividend and all the rest of the earnings may then go to the preferred stock, which is a very unusual arrangement.

Preferred stock had its origin in railroad reorganiza-

tions. In reorganization after bankruptcy it is necessary to cut down the claims of the various bond issues outstanding in order to put the reorganized corporation in a reasonably safe condition. The interest on the first mortgage bonds is usually scaled; some of the junior issues are perhaps turned into income bonds; and in the seventies some bright mind conceived the idea of changing the inferior bond issues into preferred stock. This process will be explained much more fully in our discussion of bankruptcy and reorganization.

48. *Uses of preferred stock.*—Although preferred stock was originally the offspring of receiverships, it proved to be such a useful instrument for some purposes that it has been retained and is now much used, especially by industrial companies. The railroad companies, for reasons that will be later discussed, are gradually giving it up.

Apart from its usefulness already alluded to in cases of reorganization, preferred stock serves four other purposes. First, it may be a convenient means of separating a company's stock into different voting classes. Sometimes the preferred stock has no vote at all; sometimes it elects a limited number of directors. In either case the owners of the majority of the common stock may elect a majority of the board of directors. Therefore, a much smaller interest will control the business than would be necessary if all the stock issued voted alike.

Second, preferred stock is often very useful in forming industrial consolidations. As we shall see in the study of these consolidations, they are usually capitalized for a great deal more than the combined capitalization of their subsidiary companies. Ordinarily the extra capitalization, which represents prospects, takes the form

of common stock, and the present value of the plants and businesses absorbed is represented by bonds and preferred stock. The subsidiary company stockholders are much more inclined to exchange their common stock for preferred stock in the consolidation than they would be to exchange for common stock. If the subsidiary businesses have been successful and profitable it is reasonable to expect that dividends on the preferred stock can be paid, whereas nobody can foresee whether common dividends will be paid or not.

The third purpose of preferred stock is to facilitate the incorporation of a business which has been conducted as a partnership. In a partnership each partner has as much say with regard to affairs as any other partner, irrespective of the extent of his interest. It is true that in practice the senior partner usually controls, but in law they are all on the same footing. They may desire to preserve the same arrangement in the corporation, in which case they may create a non-voting common stock and assign that stock to each partner in proportion to his interest in the partnership and in addition may make a voting preferred stock, of which each partner receives an equal amount. In this case it is possible that the so-called preferred stock may have preference in nothing except voting power.

Fourth, preferred stock obviously may attract conservative investors who would not care to buy the more speculative common stock of a corporation. Preferred stock, in point of security, ranks between the lower grades of bonds, which are described in succeeding chapters, and common stock. The preferred stock of industrial corporations, on account of their fluctuating earnings, usually sells at much better prices than the common stock of the same corporations, even though the common

stock may receive on the average as large or larger dividends.

Sometimes a certain amount of stock will be set aside at the organization of a corporation and given voting power, which right is denied to all the other stock. In such a case the corporation has in existence two classes of stock, "voting" and "non-voting." This is not at all a common arrangement and is rarely, if ever, adopted except when a partnership business is put into the corporate form. It amounts to the same thing as creating preferred stock with the preference confined to the privilege of voting.

49. *Cumulative voting.*—Originally the universal custom as to the voting power of corporate stock was to give one vote to each share. The custom is still general, at least so far as common stock is concerned, but is no longer universal. Certain important modifications of the custom, which have become more and more popular, should be noted.

The chief objection to the original custom is that it puts the control of the corporation absolutely in the hands of the owners of the majority of the stock. Under this custom they elect, not merely the majority, but all of the members of the board of directors. Hence the minority stockholders may find themselves unrepresented and absolutely powerless. This is unfortunately the condition of the minority in almost all American corporations.

In order to provide to some extent against this acknowledged evil and the abuses which are likely to follow, it is very common in England to restrict the number of votes allowed to any one stockholder. Thus a man with ten shares or less may be allowed one vote for each share; for each additional share up to twenty he may get

only one-half of a vote; for each additional share up to forty he may get only one-quarter of a vote, and so on. As each company prescribes in its by-laws its own rules as to voting, there are naturally a great many variations of this arrangement. The object evidently is to give the great body of small stockholders a voice in the management of the company and to make it impossible for any individual or small clique to gain absolute control without owning all or nearly all the capital stock. At first glance this arrangement seems admirable. It would be so easy, however, for a large stockholder to have his stock transferred in small lots to various employees and members of his family, and thus retain full voting power for that stock, that it is certain that the principle could never be made to work effectively under American conditions. The only reason that it is moderately successful in England is that stock is on the whole more widely scattered and held in smaller lots than in this country.

A far more effective method of attaining the same end is "cumulative voting." Under this method each share has as many votes in electing directors as the number of directors to be chosen. These votes may be scattered among the nominees or concentrated on one or two of them as the stockholder sees fit. The effect is to make it impossible for a majority to elect all the board; the minority at least secures representation.

To illustrate the working of this method, take a corporation in which there are 1000 voting shares and five members of the board of directors to be elected; each share, then, is entitled to five votes. We will suppose that there is an organized majority of 550 shares and an organized minority of 450 shares. Under the usual arrangement a majority vote would be cast for five nominees, all of which would represent the majority stock-

holders. Under the cumulative voting system. however, each share having five votes, the majority would cast altogether 2,750 votes and the minority 2,250. The majority could safely give 916 2-3 votes to each of three nominees and thus elect a majority of the board, leaving the other two directors to be elected by the 2,250 votes of the minority. But if the majority should attempt to elect four directors they could give only 687½ votes to each of the four, whereas the minority, if well organized, could concentrate their votes on three directors and give each one 750 votes, thereby electing a majority of the board. To make the system and its possibilities perfectly clear, it would be well for each reader to construct mentally a number of similar hypothetical cases and to observe how readily a minority under this system may secure control of the board of directors, if the majority stockholders are too greedy.

Cumulative voting is an ingenious and generally a highly desirable method of conducting corporate elections. As was stated once before, the constitution of Pennsylvania contains a clause requiring that all corporations organized under the laws of that state shall conduct their elections by the cumulative voting method. Opinions may differ as to the propriety of including such a provision in a state constitution. There can hardly be a doubt, however, as to the wisdom of putting it into the charters of most corporations.

50. *Voting trusts.*—Another method of protecting the interests of minority stockholders and of the creditors of a corporation is the formation of a voting trust. This is an agreement under which a majority of the voting stock of a corporation is placed in the hands of trustees who are authorized to vote it under whatever limitations may be prescribed. The trustees usually issue in return

for the stock so deposited "voting trust certificates," which certify that the stock is held in trust by the trustees and which may be sold and transferred in the same manner as certificates of stock. As the trustees are usually men of high standing who are under instructions to vote the stock for certain officials or in behalf of certain measures, the minority stockholders may safely feel that so long as the agreement exists no radical change in the policy of the corporation can take place, and the rights of all stockholders alike will be respected.

A voting trust agreement which seriously restricts the freedom of the majority stockholders of a corporation is, of course, not likely to be acceptable to those stockholders. The agreement, therefore, as might be expected, is not often made except under strong pressure. It is most frequently used either when a corporation is first formed and can secure additional capital on no other terms; or when a corporation is in financial difficulties and its creditors are in a position to demand that the management be intrusted to certain men and that a well-defined policy be pursued.

51. ***History of a large Canadian holding company.***— The most notable example of recent years of the formation of a holding company in Canada was that of the Dominion Steel and Coal Corporation, Limited. This concern was incorporated, issued new stock, and them controlled both the Dominion Iron and Steel Company and the Dominion Coal Company, formerly separate corporations. The history of this transaction is interesting and illustrates many of the principles enunciated in this volume. It is necessary to consider it briefly, as leading up to the foundation of a holding company to control two corporations which were previously fighting in the law courts.

Dominion Coal Company was incorporated and began operations in 1893.

Dominion Iron and Steel Company was organized in 1899, many directors being also directors of the coal company.

Steel Company erected works and began to operate in 1901.

Steel Company entered into contract with Coal Company for supply of coal at $1.20 per ton.

Steel Company took lease of Coal Company in 1902, paying yearly rental of $1,600,000 and royalty of 15 cents per ton on all coal mined exceeding 3,500,000 tons.

Lease terminated in 1903, and Coal Company assumed full control of its own property.

Coal Company agreed on October 20, 1903, to furnish Steel Company with all coal required at $1.24 per ton, with four cents per ton for use of cars.

Steel Company, having choice, asked for coal from Phelan seam.

The coal sent to Steel Company and found to contain too high grade of sulphur for steel manufacture was rejected and frequently taken back by Coal Company. Steel Company notified Coal Company that coal was unsuitable.

Steel Company agreed to accept, without prejudice to rights under contract, 75 tons per day of rejected coal. Proposal was agreed to by Coal Company and the arrangement continued for some months.

Coal Company in 1905-6 failed to supply the full coal requirements of the Steel Company, except in winter months.

Steel Company notified Coal Company on March 30, 1905, that because of increased work 80,000 tons of coal would be required in April, 1906.

Coal Company replied: "We shall endeavor to prepare to meet your increased requirements."

Steel Company gave notice on April 30, 1906, of 80,000 tons of coal for August, September and October, 1906, respectively.

Coal Company supplied only 58,270, 50,525 and 62,618 tons respectively.

Steel Company was compelled to purchase 19,000 tons elsewhere to operate works.

Steel Company having agreed to accept without prejudice to contract rights, slack coal and banked coal, so as to receive sufficient coal, and Coal Company failing to deliver right quantity, Steel Company notified they would not accept any coal except from Phelan seam, which coal was satisfactory.

After November 1, 1906, Coal Company's cars sent to Steel Company were labelled "Run of Mine, Phelan Seam," while previously cars were labelled indicating pit from which coal was taken.

Steel Company analyst was thus compelled to analyze coal, and found much of it unfit for steel manufacturing. Steel Company rejected this coal.

Coal Company gave notice of termination of contract on ground that Steel Company had made a breach by refusing the coal.

Steel Company closed works about November 9, 1906, until coal could be procured elsewhere.

A temporary contract was made between Steel and Coal Companies for supply of coal at a price much higher than that specified in contract of October 20, 1903.

Judge Longley decided dispute in favor of Steel Company on September 16, 1907.

Coal Company lodged appeal with Privy Council.

Coal and Steel interests met in Toronto to endeavor to arrange a settlement, April 15, 1908.

December 1, consolidated appeal of the Dominion Coal Company opened before judicial committee of Privy Council. Privy Council gave judgment in favor of the Steel Company.

The conclusion of the Privy Council's decision reads:

> Inasmuch, however, as according to their Lordships' view, this is not a contract of which, on the authorities cited, specific performance would be decreed by a court of equity, the plaintiffs are entitled, owing to a wrongful repudiation of the contract by the defendants, to treat the contract itself as at an end, and recover damages for the loss of it, in addition to damages in respect of those breaches of it which may have been committed before repudiation, namely, to the 31st of October, 1906. A proper reference should, their Lordships think, be directed to ascertain these damages. Their Lordships therefore humbly advise that the judgment of the Supreme Court be affirmed, and that the case should be remitted to the court to have the damages under the two heads above mentioned assessed in the usual way, the appellants to pay the costs of the principal appeal. No order as to costs or the cross appeal.

Judge Longley of the Supreme Court of Nova Scotia ruled, it will be remembered, that the old contract was unbroken; that the Coal Company must perform the contract, a referee to be appointed to assess the damages payable by the Coal Company; that the damages should include all the amounts the Steel Company had paid for coal over and above $1.24 a ton; that the coal supplied from No. 6 mine was unfit for the uses of the Steel Company; that if the Coal Company attempted to evade performance of the contract, the court had power to appoint a receiver.

The Steel Company was entitled to damages for the loss of its contract with the Coal Company and to damages for breaches of the contract before repudiation by Coal Company. The Steel Company's claim of damages against the Coal Company up to May 31, 1909, was as follows:

Paid for extra cost of coal purchased from Dominion Coal Company	$1,847,550.18
Paid for extra cost of coal purchased from others	465,005.76
Damages due to short deliveries in August, September and October, 1906	132,252.75
Damages due to cessation of deliveries in November, 1906 (estimated)	479,000.00
	$2,923,808.69

The Privy Council, in London, England, the final court of appeal, in February, 1909, gave judgment in favor of the Steel Company. So far as legal rulings were concerned, the case was at an end.

The next thing known to the public was that after this lengthy corporation battle, the two companies proposed to unite interests, a very sensible decision. Mr. James Ross, president of the Coal Company, agreed to sell to a syndicate 50,000 shares of Dominion Coal common stock at $95 per share. Thus he made his exit. Other shareholders who desired were given an opportunity to sell their coal holdings on the same terms. Of that price, $25 per share was payable in cash within thirty days and ten instalments of $7 each per share at intervals of three months during a period of two and a half years, with interest at the rate of 4½ per cent, payable quarterly. This paved the way for those share-

holders who did not desire to remain as shareholders under control of the new holding company. Comparatively few holders sold their shares.

There then remained the question of the union of the companies. After the formation of the Dominion Steel and Coal Corporation, the holding company, it was agreed that Steel and Coal shares should go in on the same basis, holders of either having the privilege of exchanging them for an equal number in the new concern. A payment of $4 in cash was made to the holders of each share, in amounts of $1, payable quarterly, beginning July 1, 1910. This payment in cash was equivalent to a dividend of 4 per cent per annum for one year, and while forming part of the purchase price, was intended to obviate any call on either company for dividends until the coal strike and its effects had passed away, and the new plant of the Steel Company was completed. The surplus earnings meantime were used to strengthen the financial position of the two companies and, so far as they were used for permanent improvements, lessened the amount of securities they might otherwise issue. So did two warring corporations become united in peaceful industry.

The total capital of the new company remained the same as the aggregate capital of the two individual companies. Here is a table showing the amount of the outstanding securities of the two companies as at December 20, 1909:

		Authorized	
	Common	Pfd. 7%	Bonds 5%
Dominion Iron & Steel..	$20,000,000	$5,000,000	$20,000,000
Dominion Coal Co.....	15,000,000	3,000,000	7,500,000
Total...........	$35,000,000	$8,000,000	$27,500,000

	Outstanding Securities		
Dominion Iron & Steel..	$20,000,000	$5,000,000	$18,000,000
Dominion Coal.........	15,000,000	3,000,000	6,175,000
Total............	$35,000,000	$8,000,000	$24,429,000

The second mortgage bonds have been retired, and at the beginning of 1910, out of the $8,000,000 authorized issue of first mortgage 5 per cent bonds, only $7,414,000 were outstanding. The company had issued $10,840,000 of its twenty million authorized consolidated bonds.

The official announcement of the arrangement and damage settlement was made in the few words following by Mr. J. H. Plummer, president of the Steel Company, and now president of the holding company, the Dominion Steel and Coal Corporation:

In December last your directors found themselves in a position to acquire at par 50,000 shares of the common stock of the Dominion Coal Company, Limited, under circumstances which in their opinion made their purchase a great advantage to the company. The purchase was accordingly completed, and your directors have agreed to exchange the shares for shares in the Dominion Steel and Coal Corporation, Limited. By the formation of this corporation, the interests of the Coal and Steel Companies are practically merged, to their common advantage.

Following on the purchase of the shares, several of your directors joined the board of the Coal Company, and the president and general manager of this company became president and general manager of the Coal Company as well.

The outstanding claim against the Coal Company for damages, on account of which $2,750,000 was received in March, 1909, has been settled by payment of a further sum of $800,000. This payment covers, in addition to the damages, several other claims which have been in dispute for many years, and operates as a settlement of all outstanding accounts between the two companies.

CHAPTER VI

TYPES OF BUSINESS CORPORATIONS

52. *Further classification of corporations.*—So far, our only classification of corporations has been into the two groups, stock and non-stock. The non-stock corporation, as has been said, is adapted only for governmental, social, eleemosynary, educational or religious institutions, and not to business concerns, the prime reason being that the absence of stock leaves no machinery for obtaining capital, except borrowing, or for distributing profits. We have, therefore, dismissed the non-stock corporations as being altogether outside the scope of this volume.

Stock corporations may be further classified as quasi-public and private. Quasi-public corporations are those which perform a service for the whole community for the sake of profits to the owners of the corporation. The most conspicuous examples are steam and electric railroads, water companies, gas and electric light companies and telephone and telegraph companies. Quasi-public corporations are granted special franchises and powers, such, for instance, as the right of eminent domain, and, on the other hand, are peculiarly subject to legislative control. Private corporations are those which carry on any business, such as manufacturing, trading, and so on, without having any special franchise, entirely for the sake of profits to their owners. The great majority of corporations belong in this second classification.

We may further classify this last group on the basis

of number of owners into "close" and "open" corporations. Close corporations are those in which the shares of stock are held by a very small number of people who do not expect to transfer them. Such corporations are not much in the public eye, since their affairs are of interest to only a few individuals. Frequently a "family business," which has been organized as a kind of loose partnership for many years, is turned into a corporation and none but members of the family are stockholders in the corporation. Sometimes estates are put by executors into the corporate form for ease in transferring interests and in making the complicated adjustments attendant upon the settlement of a large estate. These are typical instances of the close corporation. By an open corporation is meant one, the shares of which are held by a considerable number of individuals and are traded in more or less. It is called open because anyone who has the money may readily buy some of its shares. Most business corporations belong in this class.

We shall have occasion frequently in this volume to refer to both "large" and "small" corporations. These words, of course, have no absolute meaning; yet in connection with corporations a fairly definite distinction between them may be drawn. Generally speaking, when large corporations are mentioned we shall have in mind the companies which operate several different plants or rail lines, particularly the big railroad consolidations and industrial trusts. A corporation which has only one plant, even though it be of considerable importance in its own community, for our purpose may be put into the class of small or local corporations.

Two types of business corporations that are both prominent and important in present-day industry are the parent company and the holding company. These two

types are frequently, even usually, confused, although the distinction between them should be kept in view.

53. *The parent company.*—A parent company is one that for some reason does not desire to carry on operations in its own name over the whole country, and which therefore organizes and holds all or nearly all the stock of one or more subordinate companies. There may be several reasons for so doing. The parent company may wish to operate in other countries than the United States, in which case it will obviously be necessary to form a separate corporation in each country. Several English companies, for instance, have subordinate companies in this country and a great many American companies have British subordinate corporations. Another reason for this method of organization is to avoid excessive local taxation. As the capitalization of each of the subordinate corporations may be low, and as the parent company is not officially known to the authorities of the states in which the sub-companies are located, the taxes paid to these states are by this means much reduced. Another frequent reason is that it is desirable to have local men in charge of various plants of the corporation and to give these men a stock interest, not in the corporation as a whole, but in the branch under their control. This is best accomplished by the organization of a subordinate company at each branch. Obviously a parent company is also a holding company in the sense that it owns the stock of other corporations; but these subordinate companies have been created by its officers in its interest, and are in reality simply forms in which sections of its business are organized.

54. *Nature of a holding company.*—A holding company proper, on the other hand, using the term in a financial, not a legal, sense, comes into existence for the

purpose of buying control of pre-existing companies. Its ostensible object is the buying of securities of other corporations to be held for whatever revenues they will produce. The real object of its existence, however, is not accomplished unless it holds control of all its subsidiary companies and directs their operations. Sometimes this control consists in holding a bare majority of the voting stock of the subsidiary; but it is generally advisable to secure as much stock as possible, for the greater the extent of the control, the more readily may the holding company carry out its plans to achieve economies and fix prices. As we shall see in our later discussions of industrial combinations, the process of economizing frequently involves loss to one or more of the subsidiary companies; that is to say, production is often concentrated in the best plants and the poor plants are allowed to fall into decay. If there is a considerable minority interest in any of these poorly equipped subsidiary companies, there will inevitably be strong objections and legal obstacles to the plans of the holding company. It is also to the holding company's interest to own as much as it can get of the stock of those subsidiary companies the business and profits of which it intends to expand.

Thus a holding company almost always aims to become practically the sole stockholder in its subsidiary companies, so that it may operate their properties unhindered. Although in theory it merely holds securities, in practice it is the virtual owner of the railroads, the mines, the plants and the other property of its subsidiaries. We see an expression of this dual relation, the nominal and the virtual, in the reports of almost all holding companies. In these reports we almost always find two balance sheets and two income statements. The

first balance sheet shows as assets of the holding company simply the securities in its treasury and the first income statement reports merely the dividends and interest received on those securities; the second balance sheet—usually called "consolidated" or "general"—shows as assets the physical property of the subsidiary companies and the second income statement shows their combined profits. A lack of knowledge of these simple facts has frequently caused confusion in the minds even of stockholders of holding companies, many of whom do not understand the status of their own company.

55. *The holding company as a means of organizing "trusts."*—The holding company is the method now used in organizing those vast industrial and railroad consolidations that are called trusts. Two former methods of forming such combinations were pools and trusts—this word being used in this instance not in its popular, but in its legal sense. The pool is a more or less formal agreement among manufacturers of any given commodity to limit production and to maintain prices; sometimes this agreement includes the organization of a central selling agency through which all the manufacturers dispose of their product. Trusts—in the legal sense—worked on a different principle; the holders of the voting securities of competing companies turned over at least a majority interest in each company to one man or a small group of men to hold in trust, and received in return what were known as trust certificates. In other words, a single voting trust for a number of competing companies was formed. The trustees had power to vote all the stock in their possession and thus exercise control over the policies of competing companies. Pools proved to be unworkable and trusts illegal, for reasons which it belongs to the science of economics rather than to corpo-

ration finance to discuss, and both have been given up in favor of the modern form of combination, the holding company.

The holding company was first made possible in 1889 by an amendment to the corporation law of the State of New Jersey, which reads as follows:

> Any corporation may purchase, hold, sell, assign, transfer, mortgage, pledge, or otherwise dispose of the shares of the capital stock of, or of any bonds, securities, or evidences of indebtedness created by any other corporation or corporations of this or any other state, and while owner of said stock may exercise all the rights, powers, and privileges of ownership, including the right to vote thereon.

Professor Edward Sherwood Meade, of the University of Pennsylvania, includes in his valuable work on *Trust Finance* some remarks as to the meaning and results of this Act which are of such interest and importance that they are presented below in full:

> For momentous consequences, this statute of New Jersey is hardly to be equaled in the annals of legislation. Sixteen sovereign states had passed searching and stringent laws in prohibition of any attempt to restrict competition; laws whose detailed minuteness of specification could hardly be improved upon; which had been proved effective against the only permanent form of competition regulation yet attempted, and which undoubtedly represented the conviction of a majority of the people of the United States—a conviction finding more general and authoritative expression in the Sherman Anti-trust Law, and strengthened by the anti-monopoly provisions of the common law; a well-nigh unanimous sentiment opposed to any form of trust or pool; and the little State of New Jersey, containing two per cent of the population and one and three-tenths per cent of the wealth of the United States, by the simple act of amending its corporation law, nullified the anti-trust laws of every state which had passed them.

A trust could not exist in New York. The courts of New York would not allow the creation of a holding company to perpetuate the trust under another and slightly different form. Here are, say ten corporations, all located in New York, which were formerly engaged in competition, later organized into a trust, and more recently dissolved by the New York courts. The owners of these corporations, having experienced the benefits of combination, wish to continue their organization under another form. They apply to the New York Legislature for permission to charter a new company which shall purchase all their stock, and whose officers can thus control their united policy. The Legislature refuses the application on the ground that the new corporation would be the old trust under a new name, and would therefore be existing in violation of the same law which had been recently employed against its predecessor. The case of the stockholders seems hopeless. They are citizens of New York. Their corporations are chartered by New York. New York absolutely forbids them to combine in restraint of trade. What are they to do?

In despair they turn their eyes southward. There, upon the other side of the North River stands the State of New Jersey, beckoning them with welcoming hands. For a franchise bonus or fee, New Jersey will come to their assistance. New Jersey will authorize them to form a corporation which is empowered to buy the stocks of their ten companies. New Jersey will allow them, as a New Jersey corporation, to perfect the combination in New York—for operation in New York—which the laws of New York absolutely forbid. New Jersey will thus deprive the State of New York of the right to control, in the interests of what her Legislature considers to be public policy, the corporations which New York has created and over which it assumes sovereign power. New Jersey will perform a similar office for any body of individuals who may wish to evade the anti-trust laws of any State in the Union. As a New Jersey corporation, they may combine and coalesce for the operation of any number of competing plants, anywhere in the United States, with none to molest or make them afraid.

This quotation is not intended to give the impression that holding companies are necessarily formed in every instance for unlawful or harmful purposes. On the contrary, the writer wishes to record here his conviction that some form of industrial and railroad combination under present conditions in this country is both inevitable and desirable. It is inevitable because by means of combination production as a rule can be carried on more cheaply than would otherwise be possible; it is desirable because through the working of economic forces the advantages gained by this cheapness of production will be distributed in the long run among all classes. To defend and illustrate this proposition would lead us too far away from our main subject. The statement is worth bearing in mind, however, especially by those persons who are prone to join in thoughtless outcry against the "trusts."

56. *Complexity of holding companies.*—Holding companies may be formed, not only to acquire stock of operating companies, but also to obtain control of other holding companies; then there is no reason, of course, why the stock of the second holding company should not be purchased sooner or later by a third still greater holding company. Thus there may be built up a most intricate and extensive organization, in which so many companies may be involved that it becomes a difficult matter to trace their relations to each other. Many examples, each of which would require considerable explanation, might be given. The reader will get a sufficiently clear idea, however, as to how complex organizations of this kind are built up if he will study the accompanying chart of the Interborough-Metropolitan Company, which was prepared for the Public Service Commission of the First District of the State of New York. The

Interborough-Metropolitan Company controls all the street car, elevated and subway railway lines in the principal boroughs of New York City. It was formed, as shown in the chart, by an exchange of its securities for the securities of two formerly competing companies, the Metropolitan Securities Company and the Interborough Rapid Transit Company. The relations of these two companies to each other, to their direct subsidiaries, and to the subsidiaries of their subsidiaries, are as clearly as possible presented in the chart.

57. *Organization of the Standard Oil Company.*—To illustrate further the extent, as well as the complexity, of the organization of a great holding company, there is presented below the most complete list ever published of the subsidiaries formerly controlled by the Standard Oil Company. The reader will find this list of value, not only for the present purpose, but for future reference. The Standard Oil Company of New Jersey was the "parent" of something over half of the subsidiaries shown in this list; it was a true holding company, in the sense in which that term has been defined in this chapter, so far as the other subsidiaries named were concerned.

I. COMPANIES WHOSE STOCK WAS OWNED DIRECTLY BY THE STANDARD OIL COMPANY

Name.	*Total Capital Stock.*	*Per Cent Owned by Standard.*
Anglo-American Oil Co., Ltd	$5,000,000	100
Atlantic Refining Co	5,000,000	100
Bedford Petroleum Co.	350,000	99.3
Borne-Scrymser Co.	200,000	99.9
Buckeye Pipe Line Co	10,000,000	100
Carter Oil Co	2,000,000	100
Chesebrough Mfg. Co	500,000	55.5
Continental Oil Co.	300,000	100
Colonial Oil Co.	250,000	99.7
Crescent Pipe Line Co	3,000,000	100

Name.	*Total Capital Stock.*	*Per Cent Owned by Standard.*
Clarksburg Light & Heat Co.	$ 100,000	51
Deutsch-Amerikanische Petroleum Gesellschaft	2,250,000	100
Deutsch-Amerikanische Petroleum Gesellschaft (share warrants	5,250,000	99.9
Empire Refining Co.	100,000	78.5
Empreza Industrial de Petrolio	500,000	70
Eureka Pipe Line Co	5,[illegible]0,000	100
Forest Oil Co.	?	?
Gilbert & Barker Mfg. Co	40,000	100
Galena-Signal Oil Co., pfd	2,000,000	74.4
Galena-Signal Oil Co., com	8,000,000	70
Hazelwood Oil Co.	?	?
Hope Natural Gas Co.	500,000	100
Indiana Pipe Line Co	1,000,000	100
Interstate Cooperage Co.	200,000	100
Lawrence Natural Gas Co	450,000	100
Mahoning Gas Fuel Co	150,000	99.9
Marion Oil Co.	100,000	50
Mountain State Gas Co	500,000	100
National Transit Co.	25,455,200	99.9
New York Transit Co	5,000,000	100
Northern Pipe Line Co	4,000,000	100
Northwestern Ohio Natural Gas Co	2,775,250	59.4
Ohio Oil Co	10,000,000	99.9
People's Natural Gas Co	1,000,000	100
Pennsylvania Lubricating Co	50,000	60
Pittsburg Natural Gas Co	310,000	100
Romano-Americana	2,500,000	100
Reserve Gas Co.	2,225,000	50
Raffinerie Française	80,000	100
River Gas Co.	190,000	52.6
Solar Refining Co.	500,000	99.8
Southern Pipe Line Co.	10,000,000	100
South Penn Oil Co.	2,500,000	100
South West Pennsylvania Pipe Lines	3,[illegible]00,000	100
Standard Oil Co., California	17,000,000	99.9
Standard Oil Co., Indiana	1,000,000	99.9
Standard Oil Co., Iowa	1,000,000	100
Standard Oil Co., Kansas	1,000,000	99.9
Standard Oil Co., Kentucky	1,000,000	99.9
Standard Oil Co., Nebraska	600,000	99.9
Standard Oil Co., New York	15,000,000	100
Standard Oil Co., Ohio	3,500,000	99.9
Swan & Finch Co.	100,000	100

Name.	*Total Capital Stock.*	*Per Cent Owned by Standard.*
Underhay Oil Co.	$ 25,000	98.8
Union Tank Line Co	3,500,000	99.9
Vacuum Oil Co.	2,500,000	100
Waters-Pierce Oil Co.	400,000	68.6
West India Oil Refining Co	300,000	50
West Virginia Oil Co	200,000	50.6
West India Oil Co.	100,000	99.5
Washington Oil Co.	100,000	71.4

II. COMPANIES WHOSE STOCK WAS OWNED PRIMARILY BY SUBSIDIARY COMPANIES.

Amerikanische Petroleum Anlagen	$187,500	100
Automaat Co.	10,000	100
Eschweiler Petroleum Import	7,500	25
Ghent Petroleum Co.	200,000	60
Hollandsche Petroleum Vereeniging	12,000	100
Mannheim Bremer Petroleum Actien Gesellschaft	750,000	100
Petrolifere Ghent	20,000	74.5
Petrolifere Nationale	10,000	100
Petroleum Raff. vorm August Korff	375,000	54.6
Societe Anonyme H. Reith Co	412,500	61
Rheinische Petrol. Actien Gesellschaft	250	100
Actien Gesellschaft Atlantic	287,500	60
American Petroleum Co.	3,140,000	51.3
Street Tank Wagon Business-Duren	4,250	71
Gibraltar Petroleum Co.	25,000	100
Imperial Oil Co., Ltd	4,000,000	83.1
Det Danske Petroleums Aktieselskab	756,000	51.3
Tidewater Oil Co.	20,000,000	31.1
Tank Storage and Carriage Co., Ltd., pfd	300,000	100
Tank Storage and Carriage Co., Ltd., ordinary	42,195	100
Societa Italio-Americana per Petrolio	1,000,000	60
Aktieselskabet Ostlandske Petrol. Cie	162,000	9.2
Krooks Petrol. og Olje Aktiebolag	270,000	10
Skanska Petroleums Aktiebolaget	135,000	60
Svenska Petroleums Aktiebolaget	27,000	75
Sydsvenska Petroleums Aktiebolaget	98,550	24.7
Westkustens Petroleums Aktiebolag	177,500	15.3
Koenigsberger Handels Compagnie	575,000	49.8
Petroleum Import Compagnie	80,000	100
Schweizerische Petroleum Handels Gesellschaft	60,000	60
Societe Anonyme Petrolea	80,000	66.5
Wachs. & Flossner Petrol. Gesellschaft	25,000	100

Name.	*Total Capital Stock.*	*Per Cent Owned by Standard.*
Westphalische Petroleum Gesellschaft	$ 25,000	100
S. T. Baker Oil Co.	50,000	100
Galena Oil Co.—Société Anonyme Française	40,000	100
Queen City Oil Co., Ltd	200,000	87.4
Connecting Gas Co.	825,000	49.9
Cumberland Pipe Line Co	1,000,000	99.9
East Ohio Gas Co.	6,000,000	100
Franklin Pipe Line Co.	50,000	39
New Domain Oil and Gas Co	1,000,000	99.9
Prairie Oil and Gas Co	10,000,000	100
St. Paul Petroleum Tanks (Lim.)	250,000	55
Societa Meridionale per Commercio del Petrolio	120,000	....
Societa per gli Olii Minerali	156,000	52.1
Société Tunsienne des Petroles	80,000	65
International Oil Co., Ltd	2,750,000	99.4
Vacuum Oil Co., Proprietary Limited	500,000	100
Vacuum Oil Co., Reszvenytarsasag	2,100,000	100
Vacuum Oil Co., Limited	275,000	99.9
Vacuum Oil Co.—Société Anonyme Française	400,000	100
Deutsch—Vacuum Oil Co	625,000	100
Vacuum Oil Co.—Societa Anonyme Italiana	100,000	100
Vacuum Oil Co.—Aktiebolag	27,000	96.6
Taylorstown Natural Gas Co	10,000	70
Total	$229,963,195	
Standard Oil Co. of New Jersey	98,338,300	
Grand Total	$328,301,495	

CHAPTER VII

SOURCES OF CORPORATE FUNDS

58. *Summary of preceding chapters.*—The first six chapters of this book cover those fundamental features of corporation law which are essential to an understanding of the financial organization and management of corporations. We have taken up in turn among other topics: the advantages of corporations over other forms of conducting business; the legal powers of the corporation; the charter; the by-laws; the duties, rights and privileges of stockholders; of directors; of officers; the process of incorporation; the factors to consider in selecting the state of incorporation; the relative advantages and disadvantages of several states; the characteristics of common and preferred stock; the use of cumulative voting and of voting trusts; the nature of a close corporation; of an ordinary operating company; of a parent company; of a holding company. All of this matter, although essential, is intended merely as an introduction to what follows. Our real subject is not the legal, but the financial, side of corporation practice, and this subject we are now ready to take up. It must not be forgotten at any stage of this study, however, that all financial measures must comply with and be in harmony with the legal principles that have been discussed.

59. *Four sources of corporate funds.*—In financing a corporation the managers may go for funds to six different sources, as follows:

(a) Active interests in the business
(b) Profits of the business
(c) Trade creditors
(d) Banks
(e) The investing public
(f) The speculative public.

There is no need of discussing in detail methods of raising funds from people who are actively engaged in the management of the corporation. Each one presumably will be fully informed as to the records and prospects of the company and will regulate his investments accordingly. In the case of close corporations the process of raising funds is simply to allow each person interested to invest as much as he can and will on terms that are settled by direct bargaining.

Profits that are not paid out from a surplus may be one of the most important sources of funds. The Carnegie Steel Company, as we shall see later, is a conspicuous example. This particular topic is fully discussed in later chapters and need only be mentioned here.

It may not be plain at first sight that the trade creditors of a concern are in reality furnishing part of the funds necessary to the business; but a moment's reflection makes it evident that a company which continually carries, say, $10,000 of accounts payable, thereby makes that amount available for its business. If the trade creditors should demand cash for every purchase, the concern would have to raise the $10,000 from some other source. In some lines of business, especially retail, a very small investment is sufficient to carry on comparatively large operations simply because long-time payments are permissible. Usually, however, the merchant or manufacturer who buys on credit also sells on credit, in which

case the funds derived from trade creditors are promptly placed at the disposal of trade debtors.

Of course, it is possible also that a business may draw its funds from the advance payments of the people who buy its products; but this is so unusual a case that it is hardly worth mentioning.

Banks are institutions whose primary function is to furnish funds for commercial enterprises. Without going into the theory of banking, it may be pointed out that banks are dealers in credit. They buy the credit of other people in the form of notes and similar obligations and they sell their own credit principally in the form of deposits. Any reader to whom this statement is not altogether clear may turn to the volume on MONEY AND BANKING for further enlightenment. In order to make its credit good a bank must always be ready to redeem promptly every check that may be presented to it for payment. Therefore, a well-managed bank will never tie up its assets in permanent investments, but will keep them always "liquid." For that reason the corporation manager can look to banks only for short-time loans, usually not longer than ninety days. We will discuss the requirements of banks in detail in the next chapter. It is enough for the present to say that funds secured from banks will almost always be short-time loans in strictly limited amounts backed by unquestionable security.

60. *The investing public as a source of funds.*—The fifth source of funds is the investing public. This phrase covers, not only individuals, but institutions. The most important classes of investors are: (a) professional and salaried people who have no business of their own in which to place their savings; (b) women and minors who have inherited money; (c) estates held in trust;

(d) savings institutions; (e) insurance companies. Business men are not investors in securities of other corporations than those in which they are directly interested to any great extent, for the obvious reason that they are apt either to put their savings into their own concerns or to seek larger returns than are offered by strictly investment securities.

One of the great problems of raising funds for many kinds of business is to arouse interest and inspire confidence in the investing public. They may be appealed to by advertisements and circular letters—a plan which is seldom successful; or they may be reached—usually with much better results—through bond and brokerage houses whose business it is to retail investment securities to their clients. This is another topic that will come up for later discussion.

61. *Difference between investment and speculation.*—This is a good place to define the words "investment" and "speculation." The former word, as it is used in a somewhat technical sense by the leading financial papers, refers to a security or other property which is practically certain, so far as human minds can foresee, not to depreciate in value. No security in which the element of risk is prominent can properly be called an investment. If the probabilities are strong, but not conclusive, that the security or property will not depreciate in value, then the terms semi-investment or semi-speculative may be applied. To illustrate, a United States Government bond is certainly an investment, and so is a first mortgage bond on any of the standard railroads. Most of the industrial bonds, however, even where the earnings are large and the prospects apparently good, would be classed as semi-investments, because there is always danger that competition or some new invention

will cut into the business. In the same way high-grade preferred stocks of successful railroads and industrial companies would be called either semi-investment or semi-speculative issues. For our purposes in this book these finer distinctions are not necessary and would perhaps be confusing. We shall, therefore, use the word "investment" in a more popular sense to include the true investment and the semi-investment or semi-speculative securities. We may define it, in its objective sense, as any security or other property the principal of which seems safe and returns on which (interest, dividends or rent) seem certain.

The great majority of corporate stocks would be classed as speculative; for no matter how promising they may be, conservative brokers would not in most cases be willing to call them safe. Calling a security "speculative," the reader should understand, is not necessarily condemning it or objecting to its sale. As a matter of fact, few corporations comparatively have anything but speculative securities to offer. Moreover, it is only by more or less speculative purchases that returns on capital above 5, 6 or 7 per cent may be obtained. Nearly all investment securities have been at one time speculative in character. When the terms "highly speculative" or "purely speculative" are used, however, it is generally safe to assume that the writer intends to convey the idea that the security in question has a very remote chance of ever getting into the investment class.

62. ***The speculative public as a source of funds.***—The speculative public may be roughly subdivided into three groups: (a) ill-informed people who do not know the difference between an investment and a speculation and who are continually placing their hard-earned money in the hands of unscrupulous promoters in the blind faith

that they are making an investment; (b) intelligent business and professional men who buy and hold for a rise speculative securities and property in the full knowledge that they are taking chances; (c) speculators who buy securities and property "on margin" in the hope of making a quick and large profit. Group (a) may be reached by means of circular letters and advertising; group (b), generally by personal solicitation or through the stock-market; group (c), usually through the stock-market. A detailed discussion of the methods of reaching and interesting possible buyers of corporate securities must be deferred. For the present our attention should be confined to the securities themselves.

Corporate funds fall into two classes: borrowed funds and owned funds. The borrowed funds are secured through accounts and bills payable, through bank loans or through bonds and mortgages. The owned funds are secured through issues of stock.

63. *Desirability of borrowing funds.*—Why should a corporation borrow funds at all? The reader will perhaps answer, as many people do, that it borrows from necessity; that as soon as possible it ought to pay off its debts, just as a man gets rid of the mortgage on his house as soon as he can. The fact is, however, that for a corporation to be out of debt is no credit to it, but rather a sign that it is either in a dangerous position or not intelligently managed. No method of raising funds is cheaper than borrowing, unless we include stealing. Therefore, a corporation should borrow as much as it can within the limits of safety.

To illustrate the desirability of borrowing part of the funds of a corporation: Suppose a manufacturing company needs $100,000 to carry on its business and produces an average net income of $6,000. If it raises the

whole $100,000 by stock issues, it will only pay 6 per cent dividends—not enough to compensate for the risks and uncertainties of the business. Now suppose that the company is dissolved and the same business is carried on under a new company which sells $50,000 of 5 per cent bonds, gets additional and larger credits to the extent of $10,000 and borrows $5,000 from banks at an average rate of 5 per cent. Then, only $35,000 stock need be issued, the income of which, after deducting interest charges of $2,750, will be $3,250, or 9.3 per cent, a satisfactory return.

Thomas L. Greene, author of "Corporation Finance," points out that a few years ago three-quarters of owned to one-quarter of borrowed funds was thought about right, whereas now the proportion in well-managed corporations is nearer one-quarter owned to three-quarters borrowed. The result has been to reduce the average rate of returns on capital and thereby to reduce cost of production and prices. In order to make profits at all under present conditions mercantile and manufacturing concerns must borrow heavily. Of course, there are limits to the safety and advantages of borrowing.

On the following pages are given five recent balance sheets (Herring-Hall-Marvin Safe Company, American Thread Company, Bethlehem Steel Corporation, A. Booth & Company, and Central Leather Company) selected practically at random, which will perhaps make these statements somewhat more vivid and concrete. Assuming that the balance sheet of the first-named concern is based on the actual value of the property (which is, to be sure, a pure assumption) we arrive at the real amount of funds utilized in the business by deducting from the total assets the item of "Patents, good-will, etc., $290,000," leaving approximately

HERRING-HALL-MARVIN SAFE CO.

Assets:	
Real estate, plant, equip., &c.	$531,148
Patents, good-will, &c.	290,000
Inventory	433,118
Cash, notes & accts. rec.	219,617
Advances, prepayments, &c.	14,834
Notes rec. discounted	4,670
Total	$1,493,387
Liabilities:	
Preferred stock	$400,000
Common stock	700,000
Debenture notes	100,000
Accts. pay. & accrd. accts	60,950
Notes payable	155,949
Notes rec. discounted	4,670
Reserves	34,422
Surplus	37,396
Total	$1,493,387

AMERICAN THREAD CO.

Assets:	
Land, water, & steam power, mills, machinery, plant & effects	$12,694,896
Stocks-in-trade at net cost	4,960,971
Accounts receivable, net	1,016,445
Cash at bankers & in hand	341,483
Sundry investments	229,840
Advance payments	38,292
Total	$19,281,927
Liabilities:	
Com. stock ($3.50 paid up)	$4,200,000
5% Pfd. stock (fully paid)	4,890,475
4% 1st mtge. bonds	6,000,000
English Sew. Cot. Co. Ltd.	351,164
Accounts payable	770,410
Bond int. accrued	60,000

Depreciation fund	2,076,987
Div. on com., payable July	588,000
Profit & loss	344,891
Total	$19,281,927

BETHLEHEM STEEL CORPORATION

Assets:	
Property account	$72,891,695
Raw materials & supplies	4,919,590
Worked materials and contracts in progress, less bills rendered on acct	5,287,144
Accts. & notes receivable	9,909,956
Miscellaneous investments	365,372
Special funds with trustee	34,462
Cash	1,963,281
Deferred charges to operation	227,800
Total	$95,599,300
Liabilities:	
Preferred stock	$14,908,000
Common stock	14,862,000
Bonds & notes outstanding	33,599,033
Notes payable	3,388,500
Accounts payable	6,259,314
Bond interest accrued	248,097
Coupons payable	235,710
Depreciation reserve	9,586,010
Reserves for relining furnaces, &c	390,069
Contingent reserve	2,413,050
Appropriated for additions & working capital	7,500,000
Unappropriated surplus	2,214,517
Total	$95,599,300

A. BOOTH & CO.

Assets:	
Cash	$510,777
Merchandise	937,976
Accounts receivable	1,556,689
Bills receivable	930,560
Unexpired insurance, R. R. mileage, etc	119,448
Treasury preferred stock	20,800
Treasury common stock	170,650
Plants, steamboats, real estate, etc	5,510,927
Total	$9,757,827

Liabilities:	
Common stock	$3,000,000
Preferred stock	2,500,000
Surplus	1,522,700
Undivided profits	203,138
Accounts payable	931,989
Bills payable	1,601,000
Total	**$9,757,827**

CENTRAL LEATHER CO.

Assets:	
Property account	**$63,219,120**
Investments	**319,987**
Leather & other finished products	**9,995,527**
Hides & leather, raw & in process, &c	**32,463,316**
Accounts receivable	**7,220,896**
Bills receivable	**448,747**
Call loans & short time investments	**5,632,274**
Cash	**1,777,227**
Deferred charges	**133,984**
Total	**$121,211,078**

Liabilities:	
Preferred stock	**$33,299,050**
Common stock	**39,701,030**
First mortgage bonds	**35,750,150**
U. S. Leather debentures	**12,000**
Real estate mortgages	**80,000**
Foreign drafts	**1,739,970**
Accounts payable	**1,021,283**
Accrued interest	**459,552**
Pfd. dividend, payable Jan. 2	**582,732**
Com. dividend, payable Feb. 2	**793,999**
Reserves	**1,333,475**
Surplus	**6,437,828**
Total	**$121,211,078**

The borrowings, including bonds, bills payable and accounts payable, are approximately $317,000, or something over 27 per cent of funds.

To arrive at the actual funds utilized in the property of the American Thread Company we should deduct from the $19,281,000 assets the depreciation fund of $2,076,000. Of the total funds, approximately $17,-200,000, about $7,750,000 is borrowed (including bonds, debts to stock- and bond-holders and to English Sewing Cotton Co., and accounts payable). The percentage of borrowing is 45.

Deducting reserves for depreciation we find funds of the Bethlehem Steel Company to be approximately $86,000,000. Borrowings are about $44,000,000 or 45 per cent.

In the case of A. Booth & Company there are funds of about $9,750,000 and borrowings of $2,500,000, or 25.6 per cent. As the firm failed in September, 1908, this low percentage of borrowing tends to confirm what has already been said, to the effect that abnormally small borrowings indicate either a weak or a mismanaged company.

In estimating funds in the Central Leather Company, it would not be improper to deduct the item of investment, although it is not large enough to make any material difference. This leaves actual funds of approximately $121,000,000, against borrowings of $20,800,000, about 80 per cent.

It goes without saying that this analysis of the five balance sheets is superficial and that the results are merely suggestive. To ascertain the exact proportion of borrowed to owned funds in each case we should have first to learn the exact, not the nominal, value of the

assets, which is an impracticable task. As it is reasonably certain that the cost in every case is less than the book value of the assets, the true percentages of borrowed to owned funds are in all probability greater than the figures given. Four out of these five corporations no doubt borrow more than half the funds they use. Other well-managed companies follow the same principle.

64. *Distribution of security issues.*—The next question to consider is: What issues of securities or credit instruments should a corporation put out and what proportion of its total funds should be obtained by each of these issues? In order to raise funds from each of the four sources outside the business itself named above, the corporation manager will offer:

SOURCES	SECURITIES
(a) To trade creditors	Bills and notes payable
(b) To banks	Notes payable and endorsed notes receivable
(c) To the investing public	Mortgage bonds and perhaps preferred stock
(d) To the speculative public	Stock.

The amount of each security offered will depend in part on the assets and in part on the earnings of the corporation.

Corporate assets in nearly every line of business fall naturally into six groups, as follows:

(a) Fixed investments essential to the business, such as real estate, buildings and machinery and, in the case of holding companies, securities of subsidiary corporations.

(b) Property that could be sold without breaking up the business, though the sale would probably be at a heavy sacrifice, such as, outlying real estate, securities of other companies control of which is not essential to the integrity of the corporation, raw materials, and goods in process.

(c) Finished products on hand.

(d) Accounts receivable.

(e) Cash.

(f) Intangible assets, such as good-will, trade marks, etc.

To the first five groups roughly correspond obligations for borrowel money, as follows:

(a) Mortgages and mortgage bonds obtainable as a rule on good terms up to 60 to 75 per cent of the appraised value of real estate; 50 per cent of buildings; 25 to 40 per cent of machinery; 50 to 90 per cent of securities.

(b) and (c) Income, profit-sharing and car-trust bonds, on a great variety of terms, preferred stock in some cases and to some extent short-term notes and bank loans.

(d) and (e) Accounts payable and bank loans.

Group (f) and the differences between the other assets and their corresponding liabilities are usually represented by stock issues and by surpluses The reader will understand, no doubt, that this classification is merely approximate and is not always followed in practice; yet an analysis of balance sheets will reveal, on the whole, a close adherence by corporation managers to the principles just stated.

In all industries, more or less, and especially in railroads and stable manufacturing concerns, the creditors of the corporation, as we shall see later, pay more at-

tention to the income account than to the balance sheet. The gross earnings of any corporation are necessarily devoted to the following purposes: (1) Operation; (2) maintenance; (3) fixed interest charges and rentals; (4) floating interest charges; (5) betterment and surplus; (6) dividends.

The stability and amount of the earnings will, of course, greatly affect—in fact, determine largely—the value of a corporation's assets, and in that way will affect the amount and kind of securities that it may wisely issue.

65. *Corporation growth and bank loans in Canada.* —In a country such as Canada, where industries are expanding at such a rapid rate, the relations of the banks and corporations are naturally extensive. During one of the recent years, no less than 4,651 new companies secured Dominion or provincial charters. The total authorized capitalization of these companies was $1,245,927,701. The largest number of companies was chartered during the week ended September 21, when 158 federal and provincial charters were granted. The largest aggregate authorized capitalization for one week was that for the week ended July 13, when the figures were $137,231,000.

The following table shows the number of companies formed in Canada during the year above mentioned, with individual capital of $1,000,000 or more:

Capital in Millions of Dollars	Number of Companies
1	147
1½	28
2	42
2½	5
3	14

Capital in Millions of Dollars	Number of Companies
3½	2
4	4
4½	1
5	17
6	5
6½	1
7	2
10	7
15	1
25	1
30	2
120	1

According to the census of manufactures taken by the Dominion government in 1911 for the year 1910, the capital employed by 4,568 industrial establishments was $800,667,122. The increase of capital employed in Canada's industries in the ten years from 1890 to 1900 was 34.76 per cent; in the decade from 1900 to 1910, 179.15 per cent; and in the twenty years, 1890 to 1910, 276.10 per cent. These few figures show clearly what a large amount of bank financing must be involved.

66. *Attitude of Canadian bankers.*—In the course of Sir Edmund Walker's evidence before the Banking and Commerce Committee at Ottawa, early in 1913, Hon. Mr. White, the Canadian Finance Minister, asked him if it was good banking to advance money on securities of new enterprises pending the sale of the bonds. Sir Edmund is quoted as replying, "It is quite proper: in fact, the industries could not be established unless this were done."

Sometimes complaints are made by persons in the Dominion to the effect that the funds belonging to their

communities are drawn to the monetary centers and there used as loans to underwriters, promoters and others engaged in the practice of high finance. But many of the large factories or industries located in suburban districts and country towns could not have been built unless the facilities for financing the underwriting operations had been available. Mr. White's question seemed to indicate that there is some difference of opinion among Canadian bankers as to whether the chartered banks should engage extensively, in this way, in the promotion of new industrial companies.

When a Canadian bank participates in the flotation of a large issue of this kind, and the securities are taken at once by the public, it, in company with the other underwriters, receives the prearranged commission, without being under obligation to take up any of the securities. Even in that case the bank will very likely be obliged to make loans to brokers on security of the newly issued bonds. If the bank has the account of the promoters of the enterprise, it will probably be required to make extensive loans to them prior to the public flotation. Some part of these loans would remain on the books after the flotation. This is what may be expected even when the flotation is entirely successful. Circumstances are not so comfortable for the bank when the issue is only a partial success; and they may be decidedly uncomfortable if the flotation proves to be a flat failure. When the public does not take the securities, the bank, as one of the underwriters, must take its proportion of the unsold securities. It may have to make loans to other underwriters to enable them to take up their loans also. When a broker or other financier enters an underwriting syndicate, he does not usually contemplate putting any of his own funds or capital into the venture, even if the flo-

tation proves to be a failure. He will count upon borrowing the requisite amount from his bankers; and he will perhaps expect the bank to carry the loan until the syndicate succeeds in finally disposing of the issue. If the securities do not sell rapidly, the bank may have the underwriters' loans on its hands for long terms. They will not, perhaps, offer to reduce the loans—except as the securities are sold—and if the banker suggests reductions they may not receive his suggestion kindly.

67. *How the Canadian bank makes loans to corporations.*—The supervision of loans and credits by the Canadian banks obviously involves great responsibility. We may explain here the system of one Canadian bank which has been successfully carried on for several years. The borrower is expected to have only one banker, or, if the account is very large and there are two or more bankers, there is a clear agreement as to their respective shares of the bank advances. A bank credit is never established for more than one year, and expires on a particular day. The manager in charge of the account is expected to arrange for its renewal before the date of expiry. If this is not done, the account falls automatically into the irregular class and is under the eye of the superintendent's department until the credit is re-established. A new credit or the renewal of a credit will not be considered unless the balance sheet for the year is submitted, together with as full a statement of profit and loss as is obtainable. This procedure refers only to credits involving direct advances not secured by securities or by bills of other parties for merchandise sold.

When the practice of demanding a balance sheet from every customer who desired direct loans was put into operation, it was said that it would not succeed. But it has been found that, no matter how wealthy the cus-

tomer may be, he can be induced to give his full confidence to the banker from whom he is, through his application for credit, asking practically the same thing. In lending funds for the entire requirements of a timber business, for instance, where a large expenditure in the forest precedes extensive milling operations, sums are advanced, sometimes with no other security than the mere obligation of the customer. This would seem dangerous even to the conservative English banker. The basis for the credit may be mainly the expenditure of a bank over a series of years, during which every payment out of the business and all receipts for merchandise sold pass through the bank account. Each year the balance sheet is presented, and many of its features can be roughly verified by the bank account itself.

The branch manager is expected to revalue the items in the balance sheet and to analyze it so as to separate the liquid from the fixed assets. If the liquid capital—that is the surplus of liquid assets over the floating debts—is not sufficient to warrant the belief that once a year the loans will be paid in full, the credit requires, at least, unusual justification.

There are some trades in which the payment of advances once a year would not be wise or natural, but the bank authorities have been greatly surprised at the extent to which, in the past five or ten years, they have succeeded in establishing this as a most important factor in credits.

68. *Bank loans and credits.*—Sir Edmund Walker, president of the Canadian Bank of Commerce, in an address on Banking in Canada, before the London Institute of Bankers, said:

Apart from the transactions in New York or at other points, where that portion of our reserves which may safely be placed

in call or on short loans on securities is carried, the Canadian banking business is more closely akin to the banking of the ordinary cities, towns and villages in England than to that of London. There are practically no acceptances by other banks or by wealthy merchants, against shipment of merchandise to Canada, offered for discount. In the main it is a case of establishing a credit for the working of a particular business. I do not know what may be the opinion of outsiders regarding the carefulness or otherwise with which the lending operations of Canadian banks are carried on. It is a time of great expansion and it might be natural to suppose that the requirements of customers would be vaguely considered and the relations between banker and customer ill-defined and sometimes beyond the control of the banker. Doubtless, there is a considerable percentage of bad banking in Canada, as in other countries, but I doubt whether banks in any country are as a rule more explicit in the establishment of credits or do so upon more complete information.

We are, fortunately, forbidden from lending on real property, although it may be taken as security for an existing debt, and long experience has taught the Canadian banker to beware of advances which rest even partially upon the plant or buildings or any of the fixed assets of the borrower. In other countries such banking may be both safe and wise, but our policy is to lend by established credits only the money necessary to produce and carry the merchandise to market. Now, if a customer deals with only one bank, pays for all materials and labor in cash, makes all payments by checks on his bank, exhibits once a year his balance sheet and profits, and at the same time discusses at length the various features of his business for the purpose of having his credit re-established, it is not difficult to lend him very large sums with safety. In addition to the analysis of the balance sheet, comparisons are made with several previous years, and as all correspondence is conducted on special forms with only one subject on each form, and everything is typewritten—the carbon copies of one side of the correspondence being filed with the originals of the other side—

the banker can in a moment have before him in the correspondence and the analyzed balance sheet, practically all that he needs to know. All except the quite small credits are discussed with the boards of directors, and the system makes it possible to deal with a large number of credits at each sitting.

The growth of the loans of the Canadian banks is shown by the following figures:

1867	$ 55,469,521
1870	78,095,144
1880	125,555,284
1890	202,518,727
1900	362,004,795
1910	880,857,520
1912	881,331,981

CHAPTER VIII

SHORT-TIME LOANS

69. ***Trade credit as a source of funds.***—The preceding chapter named, without describing, the three forms in which corporations incur short-term or medium-term obligations, namely, trade credit, bank loans and notes sold to the public. We will now take up each of these forms in turn and see what we can discover as to the principles that should govern their use. Readers of this volume who are themselves engaged in an unincorporated business will perhaps read what is said as to the first two forms named with a more lively interest if they reflect that the principles laid down apply to partnerships or to individual proprietorships as well as to corporations.

The funds raised from the trade creditors of a corporation are secured simply by buying goods on credit. It is not customary in most lines of business to demand cash immediately on delivery of goods, except from concerns that are considered untrustworthy. Thirty days is usually allowed before trade creditors begin to press for payment and a company whose business is worth having can often considerably lengthen the average time of settlement, if that policy proves desirable. In some lines—especially when the sales are in large lots—sixty to ninety days, or even six months, is the usual allowance. For sixty days or over the debtor company generally gives a formal promissory note or else accepts a time draft which amounts to about the same thing.

As was indicated in Chapter VII, it is good business policy for a company to take as much trade credit as it can get on advantageous terms and with safety. These two qualifications are worth elaborating. A company does not obtain trade credit on advantageous terms: (a) when by so doing it acquires a reputation for "slow pay" which makes dealers unwilling to quote to the company their lowest prices; (b) when by so doing it loses the benefit of cash discounts larger than the prevailing discount on bank loans,—provided in this case that the company is not already borrowing as much as it should from banks. A company cannot accept trade credit with safety when by so doing its short-time liabilities are brought up nearly equal to its quick assets. Notice that the relation is not between total liabilities and total assets, but between quick liabilities and quick assets. A concern must have cash funds at hand to meet its accounts and bills payable when due and no other assets, no matter how valuable, will serve the purpose. A failure to realize just that simple fact has been responsible for many an unnecessary bankruptcy.

Taking the five balance sheets previously referred to (see pages 112-114), we find:

(1) That on the date of the balance sheet the quick liabilities of the Herring-Hall-Marvin Safe Company were about 100 per cent of quick assets and about 33 per cent of all the current assets, including stocks, work in process and materials.

(2) That the corresponding percentages for the American Thread Company were 58 per cent and 18 per cent. (Current liabilities, including debt to English Sewing Cotton Company, in proportion to current assets, including stocks, investments and advance payments.)

(3) That the corresponding percentages for the Bethlehem Steel Company were 81 per cent and 42 per cent.

(4) That the corresponding percentages for A. Booth and Company were 83 per cent and 64 per cent.

(5) That the corresponding percentages for the Central Leather Company were 34 per cent and 6 per cent.

We may infer from these five representative balance sheets that a conservative company will not, as a rule, allow its accounts, bills and notes payable to run much over 75 to 80 per cent of its quick assets. This percentage is, in fact, not far from normal. It would be foolish to try to lay down any absolute rule where so much depends on the custom of each line of business, on the seasons, on the nature of the company's assets, on the ease with which bank credits may be secured, and on the general commercial outlook. Enough has been said to indicate that trade credit, though a necessity to nearly every successful corporation, may become too extensive. Further discussion of this important phase of corporation finance must be deferred until we begin a study of the financial ma gement of corporations.

70. *What reliance should be placed on bank loans?*— Bank loans are not usually to be had except on first-class security and for short periods. Perhaps the best method of considering the advantages and disadvantages of bank loans will be to run over hastily the detailed statements which many conservative banks now require applicants for loans to file with them. A blank form of such statements, adopted by the New York State Bankers' Association, and widely used, is presented on pages 108-109. Let us see how critically a banker will examine one of these statements when presented by a corporation with which he is not thoroughly

STATEMENT FORM FOR CORPORATIONS

FROM ....

ADDRESS..

To KNICKERBOCKER NATIONAL BANK, NEW YORK.

For the purpose of procuring credit from time to time with you for our negotiable paper or otherwise, we furnish the following as a true and accurate statement of our financial condition on............190...., which you are to consider as continuing to be full and accurate until we give you written notice of change.

ASSETS					LIABILITIES				
Cash on hand					Notes Payable given for merchandise				
Cash in the following banks					Notes Payable negotiated to own banks				
Name of bank					Notes Payable otherwise disposed of				
" " "					Accounts Payable				
" " "					Deposits of Money with Us as follows				
....					By.................. $..................				
Notes Receivable (not transferred)					By.................. $..................				
Accounts Receivable (not transferred)					By.................. $..................				
Notes and Accounts Receivable of officers (not transferred)					By sundry persons $..................				
Merchandise finished (how valued ....)					....				
" unfinished (how valued ....)									
" raw material (how valued ....)									
Land owned by company used for this business					Bonds Outstanding........................				
Buildings " " " " " " "					Mortgage Debt........................				
Machinery " " " " " " "					Chattel Mortgages........................				
....					Capital Stock........................				
....									
....					....				
TOTAL					TOTAL				

CONTINGENT LIABILITY: Notes Receivable of customers Discounted or Sold and not included in assets enumerated above...

Other contingent liability........................

We Have Not Pledged or Assigned any of the above Accounts Receivable; our Assigned Accounts Receivable amount to........

Other assets used as collateral........................

INSURANCE: on merchandise $............buildings............$............machinery $............ Total Insurance

BUSINESS and RESULTS: Annual Sales for the year ended............190...or from............190...to............190..

Gross Profits on Sales — For the same period

Expense of Conducting Business " " " "

Net Profit " " " "

Other Income, including investments " " " "

Combined Profits " " " "

DIVIDENDS PAID ....from............190...to............190..

BAD DEBTS for the period from..................190...to..................190..

OFFICERS: name ....

" ....

" ....

" ....

BANK ACCOUNTS, where kept other than above....................

MORTGAGES: on what assets a lien....................

Average **TERMS** on which we **SELL**....................

Average **TERMS** on which we **BUY**....................

DATE of ORGANIZATION of CORPORATION....................

TIME OF YEAR when NOTES and ACCOUNTS RECEIVABLE of CUSTOMERS, Uncollected, are generally maximum........minimum........

TIME OF YEAR when STOCKS of MERCHANDISE on hand are generally maximum....................minimum....................

TIME OF YEAR when LIABILITIES are maximum....................minimum....................

STATEMENT: is it based on actual inventory?....................if so, Date....................

VERIFICATION: have the books been audited by a Certified Public Accountant?..............if so, Name and Date of Audit..............

....

BUSINESS: what kind of business do you conduct?....................

BOOKS: what kind of books do you keep?....................

....

(Please sign corporation name)....................

Date Signed....................190...   By....................

Please Give Particulars of Each Parcel of Real Estate.

Description	Street and number	City or town and state	Title in name of	Estimated value	Mortgages	Equity
....	....	....	....	....	....	....
....	....	....	....	....	....	....
....	....	....	....	....	....	....
....	....	....	....	....	....	....
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familiar. What is said on this point is largely based on an article by Mr. William Post, Cashier of the Central National Bank of Philadelphia, in *The Journal of Accountancy,* Volume 1, page 181.

Take first the item, "notes receivable." In most lines of business notes are little given except by weak concerns, and a large amount of "notes receivable" outstanding, therefore, may indicate that a corporation has been in the habit of granting unsafe credits. Some of the principal lines in which note giving is still common are harvesting machines, plumbers' supplies and electric trolley supplies. Where notes are received to any considerable extent they are generally discounted at once by well-managed corporations. Corporations which show a large figure under this heading of "notes receivable," therefore, would be regarded by the banker with distrust.

"Notes and accounts receivable of officers," except in insignificant amounts, would naturally arouse suspicion. Ordinarily officers of corporations are expected to keep their personal obligations and the company funds entirely separate.

The valuation of merchandise should be made by means of an expert's inventory. In connection with these items a careful banker will take into consideration the possibility of extensive fluctuations in value, particularly in the case of staple articles such as pig iron, cotton, wool and metal.

The other assets specified are not of immediate interest to the banker, because they will not ordinarily be sold to meet short-time obligations. They may be considered, however, as a final protection to the banker in case the concern should go into bankruptcy.

Mr. Post suggests, "that in estimating the value of

plants, a sharp distinction should be made between buildings used for manufacturing and for merchandising purposes. A business structure, conveniently located for trade, is a good asset. It is not adapted specially to any one purpose. Even if the business which now occupies it should be withdrawn, it could be sold and applied to some other use. Its value can be easily appraised. The banker is justified, therefore, in placing a high net value upon such property when well located. With the manufacturing plant, however, the situation is entirely different. The whole building is often specialized to some particular use: if the business fails, it is very difficult to apply the premises to other purposes." Machinery is even less salable, as a rule, than a manufacturing building. In general, a concern that is not making a success of its undertaking will very seldom find buyers, except at a very heavy sacrifice, for its fixed assets.

Turning to the liabilities, we have already laid down the rule that "notes payable" given for merchandise, except in the few lines of business specified above, are not required from first-class concerns. "The second and third items," says Mr. Post, "are distinguished in order to show how much paper a concern may have with its own banks and how much it may have negotiated through a note broker. It is quite important to the banker to know how much paper a borrower has sold, as the saying is, 'on the street.' If he finds that the borrower is choking his bank account and at the same time putting a large amount of paper out into the open market, the banker is likely to arrive at the conclusion that the borrower is not keeping available any particular resource or channel which he could utilize in case of a stringency in the money market. It is a fixed rule

of financial management that a concern should not borrow largely at its bank and at the same time sell large amounts of its paper in the market. If the bank line is full, paper should not be upon the street; if made largely for the street, then the bank should be kept open."

"Accounts payable" is to be considered, of course, in contrast to "accounts receivable" and the proportions already mentioned in this chapter should be observed.

Ordinarily only close corporations would have any deposits made with them by individuals. Where there are such deposits they would be regarded as a possible source of danger, since the persons who make them are apt to be in close touch with the management and to be informed of any impending trouble in time to protect themselves—possibly at the expense of the other creditors.

Bond and mortgage debts should, of course, be proportioned to the fixed assets of the corporation. The mortgage should be very carefully examined in order to make sure that it does not cover more than the fixed assets. Sometimes a real estate mortgage will contain a clause making it a first lien also on the chattels or quick assets of the corporation. Chattel mortgages are unusual and do not often exist unless a corporation is already in serious straits.

A large amount of contingent liabilities would be regarded as a weakness. Especially is this true of the item "other contingent liability," which refers to endorsement of outside paper and to miscellaneous obligations.

Generally speaking, a corporation is not expected to assign its accounts receivable. There may be well-

grounded exceptions to this rule but the exceptions require explanation.

The item "other assets used as collateral" would be filled out normally only by commission houses among which the custom is to put up bills of lading or warehouse receipts as collateral for loans. In the United States a manufacturing company is not expected to pledge any specific asset except its fixed capital. In Canada and in Europe manufacturers obtain funds from banks upon pledge of raw material and finished products.

The banker wants to be sure that a corporation is carrying sufficient insurance; otherwise a fire or some other accident may make the assets almost valueless.

The items under the head "business and results" are important, inasmuch as they tell the banker to what extent the company may meet its obligations out of income. An expert in any particular business can tell very often by an inspection of these items whether the company is well-managed or not, for he will know how large should be the percentages of gross profits and of net profits to sales. It is very difficult for an outsider to form any sound judgment on this point. "Dividends paid" will indicate how conservative the corporation is in providing against possible future losses. The item of "bad debts" obviously shows how carefully the corporation looks after its credits.

The succeeding items are intended to answer questions with regard to the balance sheet or profit and loss statement. The banker will, of course, observe very carefully what assets are covered by outstanding mortgages and bonds. He wants to know what bank accounts are kept other than those named in the balance sheet, because some concerns may keep additional secret bank accounts with the idea of inducing the bankers

to favor them with loans. A knowledge of the average terms on which goods are bought and sold enables the banker to form an idea as to how pressing the corporation's accounts payable and as to how "quick" its accounts receivable are. By learning the time of year when accounts receivable, stocks of merchandise and liabilities are at their maxima and minima, the banker may better judge as to whether the balance sheet represents the normal condition of the corporation or not.

It goes without saying that to have the statement based on an actual inventory and to have it audited, before presentation, by a certified public accountant, will add greatly to its value in the eyes of any banker.

We have gone over this blank form at some length for two purposes: First, because it illustrates how a corporation's statement may be analyzed and how much information may be extracted from it; second, because it shows how strict and careful conservative bankers are in granting loans. The writer does not mean to say that every concern which borrows money from a bank presents such a detailed statement and has it so closely analyzed as what has been said may indicate. It is true, however, that the custom of demanding and of thoroughly inspecting such statements is growing. It is also true that a conservative corporation will not desire bank loans unless it can present a statement that would meet with the approval of any careful banker.

71. *Notes sold to the public as a source of funds.*—Promissory notes of a corporation may be given in order to raise funds from (a) concerns which supply merchandise, (b) banks or (c) the public. We have already seen how and to what extent they may be issued in the first two cases; we have now to consider the third case.

The form of the note is substantially the same in all three uses. It is a simple promise to pay and must contain the features that are essential to call valid negotiable notes, which are: (a) two parties to the contract, (b) transferability, (c) a definite sum of money, (d) definite day of payment, and (e) proper signature. It is worth noting here that as a general rule the power to bind a corporation in this manner does not belong to an officer unless it is expressly conferred on him. Nevertheless, the note of a corporation signed and in the hands of an innocent holder for value is usually binding, even if the signer acted beyond his powers. Technical objections to a note, based on its improper execution or on unauthorized uses of the money borrowed, are not usually upheld. It is worth noting also that the corporation signature should be used. Notes signed by officers in their own names, even if their corporate titles are given, or notes containing such words as "jointly and severally promise to pay" may be held as personal obligations.

The usual, although not a necessary, distinction betweent notes given in the ordinary course of trade or to banks and notes sold to the public is in the length of time of the debt. In the first-named cases they do not usually run over six months. Notes sold to the public are more likely to run from one to ten years. Two or three years is about the average period, intermediate between sixty-days to six months notes, on the one hand, and ten to one-hundred-year bonds, on the other hand. They are issued in denominations varying from $100 to as high as $100,000.

The chief objection to these instruments is that they do not appeal to any large dependable body of purchasers. The commercial banks do not care for them

because they are not "quick" enough. Comparatively few individual investors will buy them because they are to be cancelled within a comparatively short period, and the average individual investor does not choose to watch his investments closely and renew them frequently. His idea, on the contrary, is to get hold of a safe security that yields a steady return and to keep it indefinitely. The market for medium-term notes, therefore, is restricted, generally speaking, to persons of large means who are in fairly close touch with the financial world and who happen to have idle funds on hand. Such persons are most easily reached through the big financial houses and these houses almost invariably absorb note issues of any size and distribute them to their clients.

On account of the limitations of the market it is always difficult to tell in advance whether an issue of medium-term notes will be taken up by the public or not. It is still more difficult—in fact, impossible—to tell at the time of issue whether the notes can be readily renewed when the time of payment arrives. No conservative corporation manager will put out such notes unless he has first provided for their payment when due. This he may do in two ways: either by saving the necessary amount out of the corporation's income or by securing through bond issues the funds with which to pay off the notes. The first course involves cutting down the borrowings of the corporation which, as has been pointed out, is likely to be undesirable. Ordinarily the second course would be inadvisable, for if bonds are to be put out at all they might as well be issued in the first place.

This suggests the usual reason for the issue of notes to the public, namely, as a temporary expedient when

a bond issue is for the time being deferred. Sometimes a railroad is building a new branch or a manufacturing company is putting up a new building on which an issue of bonds is to be based. In the meantime medium-term notes may be issued to secure funds for construction. Again, a company in need of funds may find the general financial situation unfavorable to a bond issue and may put out notes with the intention of selling bonds before the notes come due. The practice, though often justifiable, is always more or less risky. In April, 1907, for instance, the Erie Railroad issued, for that reason, $5,500,000 of one year notes. In April, 1908, the conditions being still unfavorable, the railroad authorized an issue of $15,000,000 three year notes, of which $5,500,000 were exchanged at par for the first issue. In July, 1907, the Bethlehem Steel Company issued $1,187,000 of 6 per cent serial three, four, and five year notes, apparently for the same reason. In October, 1906, the American Locomotive Company issued $5,000,000 of one to five year notes for the purpose of paying floating indebtedness and of providing working capital. It is expected that these notes will be redeemed out of income. These examples will indicate roughly when and how medium-term notes are issued.

Although notes for the public are generally simply unsecured promises to pay, they may, especially for the longer terms, be based on certain definite property. A corporation's holdings of securities of other companies are frequently put up under mortgage as collateral security. It is difficult to draw a line between long-time collateral trust notes and short-time collateral trust bonds; in fact, notes and bonds merge into each

other and the distinction between them is in some cases merely nominal.

In this chapter we have been dealing with the current obligations of corporations. The main point with regard to them to bear in mind is that they ought to be offset, if they are to be made good, by a more than equal amount of current assets, and no other kind of assets will serve the purpose. To issue notes and put the funds thus secured into fixed or semi-fixed assets without having on hand a large surplus of current assets is unsound and dangerous financing.

72. *Canada's short-term loans.*—While short-term loans have been comparatively common during recent years in the United States, it was only during 1912 and 1913 that they commenced to appear as an important factor in Canadian finance. At that time, too, the issues of such securities by United States corporations were unusually numerous. Canadian provincial governments and municipalities were among the first to utilize this method of financing. In 1913, the movement spread to the Canadian railroads and both the Grand Trunk and Canadian Northern Railway Companies made such issues. One of the Grand Trunk issues is discussed elsewhere in this volume.

This form of financing is evidently becoming popular among corporations and, obviously, especially so in times of financial stringency. Stating that out of a total of $180,000,000 new security issues in the United States $135,000,000 consisted of short-term notes and that a year previously the June issues aggregated $299,000,000 of which only $83,000,000 were short-term notes, the *New York Journal of Commerce* commented as follows:

This phenomenal increase in short-term notes, which are largely floating debt, should arrest attention. It illustrates very plainly not only the urgent demands for capital, but also the difficulty of satisfying them.

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This is one of the evidences of the diminution in the available supply of accumulated capital often referred to. Another striking fact is that more than the entire reduction in the amount taken up in new investments pertains to industrial securities.

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These notes are put out for short time at high rates because the capital cannot be obtained on better terms. They are not issued in any considerable proportion for temporary purposes, but in the expectation, or at least in the hope, that when they mature they can be replaced with long-term obligations at lower rates. This is a matter of expectation and hope and not of calculation, and it is significant of uncertain conditions and a waiting policy.

While short-time loans have been familiar to Wall Street and Lombard Street fo some years, it would seem that this form of borrowing is being regarded with less favor, and possibly corporations will find some difficulty in the future in adopting this method of securing funds. Among the first loans raised by the British Treasury after the Revolution of 1688 was one by means of Exchequer Bills, but it was not a success; in subsequent years it became the constant practice of the British Government to anticipate revenue by means of such securities. Exchequer Bonds were first issued in 1853, but after the first issue of Treasury Bills in 1877 the former method fell into disuse, with the exception of the issue in 1889. It was revived again, however, during the South African War and is now the usual form adopted when raising money for particular purposes where the liability should cease in a short term of years.

Treasury Bills are issued each year and care is taken by the Finance Department to see that their authority to raise money in this manner does not lapse through non-use.

The advantages to be gained by raising money by means of short-dated securities (which at or before maturity are to be funded, that is, repaid by a loan raised for a longer period, say 30 to 50 years) were soon so evident that during the past decade many concerns adopted this plan. It has become quite usual, lately, during the periods of dear money, to witness the issue of large blocks of such securities. These issues are usually made by governments, municipalities, railways and industrial corporations, and occasionally by other enterprises. The attitude of the market towards them is greatly influenced by the position of money, European politics and the volume of business of this character which is being offered, and last, but not least, by the character and standing of the borrower.

Writing in *The Monetary Times Annual Review*, Canada, Mr. H. V. F. Jones, a Canadian banker in London, said:

> It is not wise to leave out of consideration the following important factor which will govern to a large extent the conditions under which the funding operation of such short loans is carried through. The London market generally becomes quickly cognizant of any plethora of securities of this description, and this knowledge tends naturally to react upon the price, not only of the securities of the government or corporation already issued and dealt in on the stock exchange, but on the price at which the new issue is to be made. Prices will tend to fall and in the long run the borrower may have to bear the chagrin of discovering that all his manœuvres to avoid a period of apparent dear money and depreciated prices, had ended in failure and possibly severe loss.

Canadian railway loans.—It will be of interest to examine an issue in London in August, 1913, of £1,500,000 (part of a total authorized issue of £2,000,-000) five per cent, five-year secured notes of the Canadian Northern Railway Company. The issue was over-subscribed by the investing public.

The prospectus states that interest is payable half-yearly and that the notes are to be in denominations of £1,000, £500 and £100, and carry a coupon for a full half-year's interest due on February 12, 1914. They are secured by the deposit with Lloyds Bank, Limited, as trustees under a deed of trust of the following securities:

Nominal Amount.		Annual Income.
£450,000	Canadian Northern Railway Company 4 per cent debenture stock, due 25th February, 1939, guaranteed unconditionally, principal and interest, by the Province of Alberta..........	£18,000
£500,000	Canadian Northern Railway Company 4 per cent debenture stock, due 23d January, 1939, guaranteed unconditionally, principal and interest, by the Province of Saskatchewan.....	£20,000
£300,000	Canadian Northern Railway Company 4 per cent debenture stock, due 30th June, 1930, guaranteed unconditionally, principal and interest, by the Province of Manitoba...........	£12,000
£550,000	Canadian Northern Pacific Railway Company 4 per cent debenture stock, due 2d April, 1950, guaranteed unconditionally, principal and interest, by the Province of British Columbia	£22,000
£750,000	Canadian Northern Railway Company 4 per cent perpetual consolidated debenture stock	£30,000
£2,550,000		£102,000

The amount required annually to meet the interest on the total authorized issue of the notes is £100,000.

The Canadian Northern Railway Company reserved the right to redeem the notes at 101 and accrued interest, either as a whole or in amounts of not less than £100,000, by drawings on any interest date on 60 days' previous notice; and in the event of any notes being redeemed before the date of maturity, the trust deed will provide that the trustees shall release proportionate amounts of the government guaranteed stocks and of the perpetual consolidated debenture stock respectively.

Immediately prior to this issue in London, a similar issue was made by the company in the United States. Two issues of short-term loans of the Grand Trunk Railway were also made about the same time.

The railway executives, in adopting this form of corporation financing, had, as usual, to satisfy the thirst of the investor for information. This is the information which Sir William MacKenzie, president of the Canadian Northern Railway Company, conveyed in a letter to Lloyds Bank, Limited (the house responsible for the issue), and which was printed in the prospectus:

The Canadian Northern Railway Company is at present operating 4,520 miles, which includes 644 miles of leased lines. In addition, about 408 miles of track has been laid on new branch lines and will shortly be opened for traffic, and about 300 miles more are under construction.

The net earnings of the company have been steadily progressive, as the following figures show:

Year ending 30th June, 1908	$3,032,687
" " 1909	3,566,362
" " 1910	4,344,390
" " 1911	4,990,347
" " 1912	5,881,045

The net earnings for the year ending 30th June, 1913, are computed, subject to final audit, to have amounted to $7,050,000.

The available net earnings exceeded the amount required to pay the interest on the 4 per cent perpetual consolidated debenture stock for the year 1909–10 by $1,030,757; 1910–11 by $1,007,695; 1911–12 by $1,250,200, and it is computed, subject to final audit, that there will be an available surplus for the year 1912–13 of $1,600,000.

At June 30th, 1912, the company had accumulated surpluses to the credit of profit and loss account:

On account of land sales	$16,874,826
On account of railway operation ..	5,986,553
	$22,861,379

74. *Three-year land notes.*—Another form of short-term financing was a Canadian offering made in the London market in 1913 in the shape of an issue of $2,300,000 six per cent, three-year notes of the Terminal Cities of Canada, Limited. The price was 97. The notes were secured upon lands with an estimated value of $5,250,000. The company undertook to pay to the trustees the net proceeds of all land sales and the interest on unpaid instalments of purchase price, and not to participate in the proceeds of the sale of lands or otherwise secure any profit until the notes had been redeemed in full.

Canadian bankers are watching closely the development of short-term corporation financing and may not be expected to encourage it greatly in Canada. They are mindful of the fact that the displacement of short-term notes by long-date securities can be done only out of the money which investors have saved. When bankers commenced to think seriously of this matter they remem-

bered the fear of London authorities that the accumulation of savings would not be on a scale large enough to take care of issues of securities which were being deferred for the time being by short-date financing on the basis of between five and six per cent.

75. *Problems of short-term loans.*—In an interview in *The Financial Post* of Canada, Sir Edmund Walker, Toronto, said that it would take more to fund the short-date notes than it would to rehabilitate the Balkan States after the devastation of the war of 1912-13. Most of these notes had been issued on a comparatively high rate accepted temporarily in the hope that conditions would change so as to permit of their displacement by long-term securities bearing a lower rate of interest. Canadian borrowers had shared in this class of financing, but by far the greatest proportion had been done by the United States railroads. It was feared, said Sir Edmund, that it would be some time before the market would be in a position to absorb, on a long-term basis, the huge accumulation which had taken place during the year.

Besides the scarcity of money saved by investors, there was another difficulty in the shape of the nature of the security back of the loans. There are some misgivings in the mind of the financial world of London as to the quality of the security.

Discussing the problems of short-term loans, a contributor in *The Financier and Bullionist*, London, said that while the Canadian Northern Railway Company might be congratulated on the success of its issue of five per cent, five-year notes (referred to previously), the episode was decidedly significant of the monetary situation and the prospects with regard to future issues on somewhat the same lines. It was not impossible

that the decision of the Canadian Northern management to adopt this means of raising further capital may have been influenced by the example of a great number of railway and other undertakings in Great Britain and in the United States. The writer continues:

There is much virtue in the redemption of securities within a moderate period and at a definite date, but, of course, short-term notes, as usually understood, are on quite a different plane. The device has to be regarded as appropriate for conditions which, though not altogether abnormal, may be said to be unfavorable for the flotation of an ordinary issue. Indeed, the principal, if not the only reason, for any commercial undertaking resorting to this form of finance, is that capitalization by means of permanent obligation is impracticable or impossible. The borrower offers short-term bonds, either because he cannot get money at a profitable rate otherwise, or because he thinks that at the end of the term he would be likely to procure capital on a permanent basis at a lower rate of interest. Now British railway companies habitually issue short-term notes to their bankers in connection with dividend payments and other obligations, but it would appear tolerably certain that any British railway company which proposed to adopt such a decree to enable it to, say, build new stations, or provide other betterments to its property, would immediately find a difficulty, perhaps a *non possumus*, in the way.

The fact is that banks in general are inclined to regard any such proposal exactly as one trader may regard a proposal by another who desires to strike a bargain. The very fact that a company needing money comes forward with a proposal of this sort indicates that there is a difficulty in raising money on permanent stock issued in the usual way. In other words, the company is in a position which has been brought about partly, perhaps, by the condition of the money market and the course of investment, and partly by some more or less obvious weakness in its own position. The proposal is that the bank

should advance so much capital at a lower rate than would have to be paid for it if an issue were made to the public.

In the case of a quite ephemeral requirement, such as that which arises in connection with dividend distributions, the security which can be offered to the bank is so perfect that low terms are given without demur, but when a company wants capital to enlarge its operations, or to tide it over an awkward time, or to use it, in fact, in any fashion which involves ordinary commercial risks, then the bank looks at the whole affair from an entirely different standpoint. In such a case the bank manager may be supposed to say: "Why should I advance you this money for three or five years on easier terms than would satisfy the ordinary investor? If I take your notes, what am I to do with them? The ordinary investor would not look at them, and it is highly probable I shall have to either put them in the cellar for the whole term or dispose of them to other financial houses, who would expect to make something out of their compliance. If you want money at this low rate of interest I expect very first class security. I see no reason why I should part with my commodity at less than its proper market value."

Before the adoption of short-term financing by those interested in corporations, serious consideration should be given to the need and the advisability therefor.

CHAPTER IX

THE CORPORATE MORTGAGE

76. *What determines the value of fixed assets?*—Now we take up the long-time obligations—especially mortgages and mortgage bonds—of corporations. Evidently they must be based on permanent, or fixed assets, and in amount will correspond roughly to the value of such assets.

Here we meet with the difficult and important question, What determines the value of fixed assets? Most people would be inclined to say that the cost of the assets must determine their value. A moment's reflection, however, shows this statement to be untrue. Suppose, for instance, that a man has put up a plant at an expense of $100,000 for refining copper, and afterwards discovers that there is no copper within hauling distance. The plant would not be worth the expense of demolishing it. On the other hand, suppose that he does put his plant in a rich copper country and secures such favorable contracts with the mine owners that he makes profits of $100,000 a year and may expect to continue such profits for an indefinite period. His plant, in that case, could be sold for perhaps a million dollars. Evidently cost of construction would have very little to do with the value of such assets.

The second opinion is that the value of fixed assets is determined by the expense of duplicating them. It is claimed, for instance, that to arrive at a fair valuation of the railroad property of the United States, all we

need to do is to figure how much it would cost to reproduce this property under present conditions. The illustration already used, however, would apply in criticism of this second opinion as well.

The third opinion is that the value of fixed assets is determined by their earning power as in the above illustration. It takes no argument to show that this is actually the case in ordinary business practice. If you were going to buy anything in the nature of a fixed asset, from a university education to a steel mill, your first question as a business man would be, How much will this asset earn for me? Similarly, an investor in buying the securities of a corporation will inquire as to the value of the corporation's fixed assets, and will naturally estimate their value on the basis of earnings—not the present earnings altogether, but probable future earnings as well.

Bear in mind that this principle that earnings determine value is applicable only to fixed assets. The selling value of floating assets, such as raw material, tools, finished goods on hand, is another matter. That will be determined, normally, as the science of economics explains, by cost of production. The difference arises from the fact that fixed assets—land, buildings, machinery—are not intended for sale, but for use. They generally have little or no value except for the purpose for which they were intended; and their value for their purpose can be determined only by their earning power.

We have already intimated without going into details that the amount of investors' securities which may be issued by any corporation depends both on the value of its fixed assets and on the amount of its income available for interest charges. There is no contradic-

tion between these two considerations. At bottom the important factor on which to base bond issues of a going concern is the amount and stability of income. We shall elaborate and emphasize this point a little later.

77. *Nature of a mortgage bond.*—The simplest method and the method most common among small corporations of borrowing long-time funds is by direct mortgage on the corporation's real property. An ordinary mortgage conveys "all right, title and interest" in a given piece of property to the mortgagee, with the proviso that the transfer is to become null and void in case principal and interest are paid as promised. Although the old common-law phrases, which would cause the whole property mortgaged to pass to the mortgagee in case of default, are generally retained in the mortgage indenture, yet the mortgage is universally regarded at law as in effect a lien. A simple corporate mortgage is in no important respect different from a mortgage by an individual or firm.

Where large sums of money are to be raised by a mortgage, however, the procedure is not quite so simple. In such a case it is customary to offer mortgage bonds in convenient denominations to the public. As the property mortgaged is for all practical purposes indivisible and as there are a large number of secured bondholders, it is impracticable to give a separate mortgage with each bond. It becomes necessary, therefore, to give the mortgage to some individual or concern, acting as trustee for the bondholders, in which case the mortgage indenture becomes a deed of trust. Each bond is a simple promise to pay, its phrasing being more formal, however, than that of a note. It is executed under corporate seal and contains a reference to the indenture between the corporation and the trustee. A

study of the sample mortgage bond printed on page 151, will serve better than a long description to show the reader exactly what is contained in a bond.

The varieties of mortgage bonds will be considered later. For the present let us take up the terms of the deed of trust between the corporation and the trustee.

78. *Essential features of a deed of trust.*—Experience has demonstrated the necessity of making this deed very exact and comprehensive. The indenture of a large railroad mortgage may contain as many as 50,000 to 100,000 words. If printed and bound it would make a good-sized book. Of course, the ordinary industrial corporation would not find so lengthy and involved a description of the property and the terms of the mortgage necessary. To the lay reader even a comparatively simple indenture is apt to seem a mass of cumbersome and more or less nonsensical legal phraseology; but it must be borne in mind that every such deed is closely scanned by a large number of able and experienced lawyers, who will demand that no possible loophole for evasion or misinterpretation shall be left open. The rights and obligations of each of the three parties to the agreement, the corporation, the bondholder and the trustee, must be fully and explicitly set forth and the mortgaged property must be described so exactly that no conflict with other mortgages or obligations can possibly arise. The instruments have now come to follow certain models and are almost always arranged about as follows:

First, of course, come the date and the names of the parties to the indenture. Next follows the preamble, in which is a full statement of the legal status of the corporation, including the state in which it is incorporated, the amount of its capital stock and bonds, the

No...... UNITED STATES OF AMERICA. STATE OF OHIO $1,000

THE COLUMBUS CONSOLIDATED STREET RAILROAD COMPANY

FIRST MORTGAGE TWENTY YEAR FIVE PER CENT GOLD BOND

For Value Received, THE COLUMBUS CONSOLIDATED STREET RAILROAD COMPANY, a corporation organized and existing under the Laws of the State of Ohio, and operating street railroads in the City of Columbus, promises to pay to the Central Trust Company of New York, Trustee, or to the bearer or registered owner hereof, ONE THOUSAND DOLLARS, in gold coin of the United States of America, of the present standard, on the first day of July, 1909 and to pay interest thereon at the rate of five per cent per annum from the first day of July, 1889, on the first days in January and July of each year, on the presentation and surrender of the coupons hereto annexed as they severally become due, until said principal sum shall be paid, both principal and interest of this bond being payable at the agency of said Railroad Company in the City of New York. (This bond is subject to redemption on or after July 1st, 1894, at 110 per cent of the par value thereof, with accrued interest, out of a sinking fund of $22,500 a year, beginning with that date as provided in the mortgage herein described.) This bond is one of a series of Eight Hundred bonds, of like tenor, date and amount, numbered consecutively from One to Eight Hundred, both inclusive, and amounting in the aggregate to Eight Hundred Thousand Dollars, which are all equally secured by a mortgage of said Railroad Company in the nature of a conveyance in trust, dated July 1st, 1889, and duly recorded, conveying all the property and franchises of said Railroad Company to said Trust Company, in trust, for the benefit of the holders of said bonds, to all the provisions of which mortgage this bond is subject. In case of default for six months after due demand in payment of any interest on any of said bonds, the principal of all thereof may be declared due, as provided in said mortgage. The principal of this bond may be registered on the books of said Railroad Company at its said agency, and registration thereof noted hereon, after which no transfer thereof shall be valid, except on said books, until after registered transfer to bearer, when the principal of the bond will again become transferable by delivery. The coupons annexed to this bond will always be transferable by delivery. This bond shall not be valid unless authenticated by the Certificate of the trustee of said mortgage.

IN WITNESS WHEREOF, said Railroad Company has caused its corporate seal to be hereto affixed, and this bond to be subscribed by its President and Secretary, and the name of its Treasurer to be engraved on the several coupons hereto annexed, at the City of Columbus, in the State of Ohio, this first day of July in the year Eighteen Hundred and Eighty-nine.

....*President.*

....*Secretary.*

[On the back.]

TRUSTEE'S CERTIFICATE.—The Central Trust Company of New York, Trustee, hereby certifies that this bond is one of the series of Eight Hundred mortgage bonds, described in the mortgage mentioned herein, bearing date the first day of July, 1899.

CENTRAL TRUST COMPANY OF NEW YORK, Trustee.
By....................*Vice-President.*

NOTICE!—No writing on this Bond, except by an officer of the Company

DATE OF REGISTRY.	IN WHOSE NAME REGISTERED.	TRANSFER AGENT.

[On the end, forty Coupons, numbered on the back, and dated each first day of January and July, from 1890 to 1909, the face of the first one reading:]

$25. Coupon No. 1.—On the first day of January, 1890, The Columbus Consolidated Street Railroad Company will pay the bearer, at its agency in the City of New York, Twenty-five Dollars, being the semi-annual interest then due on its First Mortgage Bond No............

E. K. STENORF, *Treasurer.*

amount and kind of property it owns. The preamble also presents the authority given by the stockholders and directors for the bond issue and the specific purpose of the issue. Then the full texts of the bond, the interest coupon, if it is a coupon bond, and the trustees' certificate of validity, which should appear on each bond (see form on page 151), are given.

The granting clause, which transfers the property to the trustee, and a detailed description of the mortgaged property follow. The duties of the trustee, including the statement that the property is granted only in trust, and a provision that the trustee shall certify to the validity of each bond are next set forth. This is followed by the covenant of the corporation to pay the interest and principal of the bonds at the time specified.

An important section of the mortgage is that which binds the corporation to keep the property insured, pay all taxes, assessments and charges, and in general to preserve the property and keep the lien valid. Another section retains for the company complete control of the mortgaged property and enjoyment of all the profits unless and until default is made of principal or interest.

Where a corporation has subsidiary companies it may be necessary to include a full statement as to the status and securities of each of these companies.

The sections following deal with default and foreclosures. Exactly what constitutes default must be definitely stated. Usually a short period of grace is allowed after interest payments fall due before the trustee can take action. The percentage of bondholders at whose request the trustee shall take active steps is stated, usually 20 or 25 per cent. The percentage of bondholders who must request foreclosure

and sale in order to authorize the trustee to proceed to this extent is also given; usually a majority is required. The course of action of the trustee in case of foreclosure and sale is prescribed and the proceedings in case of receivership are set forth.

The responsibilities, liabilities and compensation of the trustee are presented and provision is made for the resignation of the trustee, or his removal upon request of a majority of the bondholders, and for the appointment of his successor.

It is customary, although seemingly hardly necessary, to absolve the officers and directors of the corporation from any personal liability.

In long mortgages there is frequently a separate section in which terms and phrases used in the indenture and open to possible misinterpretation are exactly defined.

At the end appear the signatures and seals of the corporation and of the trustee through their proper officers with formal attestation of the seals.

Frequently modifications of the original document are called for by changes in the legal status of the corporation or trustee or in the corporate property. Such modifications may take the form either of a supplementary indenture or of a supplementary agreement. The latter is less formal and usually relates to comparatively unimportant matters. Supplementary indentures are most common in case of reorganization. They must be authorized by stockholders and bondholders as well as by the two parties directly concerned.

79. *Classification of mortgage deeds of trust.*—Mortgages are conveniently classified as closed, open-end, and limited open-end. A closed mortgage covers a limited amount of bonds all issued at one and the same time and absolutely forbids any additional bonds secured by the

same mortgage. The open-end mortgage authorizes an indefinite amount of bonds, some of which are issued at once and some, under certain restrictions, in the future. This type has so far been restricted to railroad companies. The usual provision is that a given amount of additional bonds may be issued for each additional mile of track constructed.

The limited open-end mortgage, which is the common and for almost all purposes the best type, names a certain maximum amount of bonds to be based on the mortgage, part of which amount is issued at once. The rest may be sold under certain restrictions as to time; usually a given amount may be put out each year. Sometimes there are further restrictions, such as a requirement for the permission of the syndicate which bought the first installment; or the requirement that interest on outstanding bonds be paid for a given period before any new bonds are sold.

The merits of this limited open-end mortgage over either of the other two types are obvious. An absolutely closed mortgage may make it very difficult for a corporation to secure additional funds with which to carry on construction that is essential to its welfare. Possibly the corporation's earnings may thereby be restricted so as to invalidate the bondholders' as well as the stockholders' interests. The open-end mortgage, on the other hand, is too indefinite. The corporation may issue so many bonds under the mortgage and may raise its fixed charges to so high a point as to bring risk or even actual loss to the bondholders. We must not forget in dealing with mortgages and mortgage bonds that in principle the holders of these instruments are supposed to be free from even reasonable risk.

CHAPTER X

TYPES OF CORPORATION BONDS

80. *Classification of bonds.*—This and the following chapter are devoted to enumerating and describing the various types of bonds that are in common use. We would recommend that they be studied with particular care; for ignorance as to the exact nature and uses of each of the bond types named may very easily prove costly both to investors and to corporations. An error that is particularly frequent in small manufacturing corporations is to create a bond issue of a type that is not at all adapted to the financial status and prospects of the corporation. One attentive reading of these two chapters would have prevented many of these errors.

Bonds may be classified with respect to:

(a) The security for their payment,

(b) Their purposes,

(c) The manner of their payment,

(d) The conditions of their redemption.

As these classifications, which should be kept quite distinct, are frequently confused, the writer has made up the following list of the words commonly used in describing bonds, each word being placed under its proper heading:

A.—*Security of Bonds.*

1. First Mortgage,
2. Second Mortgage, Third Mortgage, etc.,

3. Terminal, Divisional, Land-Grant, or other Special Mortgage,
4. General Mortgage,
5. Sinking-fund,
6. Collateral Trust,
7. Car or Equipment Trust,
8. Debenture,
9. Income,
10. Participating,
11. Profit-Sharing,
12. Joint,
13. Receivers' Certificates.

B.—*Purposes of Bonds.*

1. Unifying,
2. Refunding,
3. Construction,
4. Purchase-Money,
5. Improvement,
6. Extension,
7. Adjustment,
8. Consolidated.

C.—*Manner of Payment.*

1. Coupon,
2. Registered,
3. Registered as to principal, but dividends in coupon form.

D.—*Conditions of Redemption.*

1. Gold,
2. Redeemable,
3. Serial,
4. Convertible.

81. *Mortgage bonds.*—A bond secured by a first mortgage on all the real property of a corporation—provided the corporation is stable and prosperous and the bond issue is not large—is regarded as a highly desirable investment. You could infer this from the quotations on the first mortgage bonds of the standard railroads and industrial companies, as shown in the three examples below. It should be noted that none of these three issues is secured by an absolute first mortgage. Such issues are usually small and then prices are hard to determine.

At present prices, Baltimore & Ohio first 4's yield about 4.05 per cent; Western Union first 4's, about 4.45 per cent; and Union Pacific first 4's, about 4.02 per cent.

A debt secured by a bona fide first mortgage cannot be interfered with by any inferior security and, unless the corporation goes into receivers' hands, no security of higher rank can be put out.

It is always possible, of course, to place a second mortgage on the same property covered by the first mortgage and to follow the second mortgage by a third, and a fourth, and so on. It is very seldom possible, however, to find buyers for anything junior to a second mortgage bond. Although bonds derive their value in large part from income, yet as they are nominally based on property, investors do not like junior bonds. Their dislike is not unreasonable, for in case of reorganization the heaviest loss would necessarily fall on the holders of junior securities. Many large corporations have made every effort to give each one of their bond issues, no matter how numerous these issues may be, the appearance of being based on a first mortgage. To this

end many ingenious expedients and names have been invented.

For instance, there are many railroad divisional and terminal first mortgage bonds. Sometimes these bonds are based on property highly valuable in itself. Sometimes, however, they are first mortgages on branch lines or on terminal real estate that would be of very little use to any concern except the particular railroad that issues the bonds. In such a case the vaunted priority of the divisional or terminal bond is more or less of a fiction. A railroad could give up the branch line or the terminal real estate far more easily than the bondholders could afford to have the property separated from the railroad.

Another very common practice with both railroads and industrials is to have first mortgage bonds issued by subsidiary companies and then have a nominal first mortgage bond issued by the holding company. The holding company's bond is in reality based only on its holdings of subsidiary companies' securities and is inferior to all the subsidiary company bonds. Various names are given to these junior issues. Sometimes they are called "first and refunding" mortgage bonds, or "first general" mortgage bonds, or "first and unifying." The words "unifying," "consolidated," "refunding," and the like, used in this connection, are intended to signify that the underlying bonds will be retired as they fall due with the proceeds of the new issue. It would perhaps not be just to say that these names are intended to mislead; but at least it may be said that they put the most favorable possible construction on the terms under which the bonds are issued.

82. *Sinking fund bonds.* In the case of mines and other enterprises which have a pretty definite lease of life it is necessary for the protection of bondholders to

establish a sinking fund for the redemption of mortgage bonds. In such cases the sinking fund is frequently obtained by setting aside a certain portion of the company's income. Lumber companies sometimes reserve a certain amount on each thousand feet of lumber cut and coal mining companies a certain amount on each ton of coal mined. It is more common, however, to set aside a fixed amount each year.

There are three methods of estimating the amount that should be set aside each year. One method is to divide the amount of the debt by the number of years that the debt runs and put into the fund each year the resulting amount. This is simple enough, but decidedly crude. As no account is taken of interest on the sums in the fund, the method ties up an unnecessarily large amount of money. The second method allows whatever is put into the fund to accumulate at compound interest and therefore calls for a much smaller annual payment than the preceding method. The third method is what is known as the installment or annuity method and consists in paying equal periodic installments to the bondholders, or their trustee, to settle principal and interest in a given number of years. It calls for somewhat larger payments than the second method, inasmuch as it takes care not only of the principal, but of the interest as well. A fuller discussion of sinking fund method is unnecessary, as the subject has been covered in the volume on ACCOUNTING PRACTICE.

The sinking fund method of guaranteeing that bond issues will be paid has been much used by industrial corporations, particularly when the permanence of their business is somewhat uncertain and investors consequently are inclined to look upon their securities with suspicion. In such a case it may be an advisable arrange-

ment both for the corporation and for the bondholders. Where the corporation's assets, however, are of a permanent nature, the sinking fund is no longer regarded with favor. The objections to its use are clearly stated in the following selection from Professor E. S. Meade's "Trust Finance."

The sinking fund is of no benefit to the stockholder other than to ultimately decrease the liabilities of the company. During a long period, however, the corporation is under the necessity of paying interest, and at the same time of contributing to the sinking fund. The result of this double contribution is, for perhaps twenty-five years, to compel the stockholder to pay double for the money borrowed. The amount available for dividends is, therefore, reduced, and the stockholder suffers.

It may be argued that the stockholder will eventually receive full compensation for these smaller dividends in the reduction of fixed charges which the sinking fund will eventually bring about; but aside from the fact that it is a hardship for him to wait so long for this reward, there is the further objection that even after the reduction of liabilities by the cancellation of the bond principal, the owners of the company will have made, averaging the periods before and after the retirement of the bonds, smaller profits than if no sinking fund had been gathered. The reason for this permanent reduction of profits by the collection of a sinking fund is as follows: A sinking fund must be invested in securities. It cannot be put into betterments. In the form in which it is accumulated, a low rate of interest from the investment of these annual sums is all that can be expected. The compounding of these investments, it is supposed, equals the principal of the bonds at the time of maturity, and the corporation is thereafter freed from a portion of its fixed charges. This gain, however, is in reality a loss to the stockholders. If the money which has gone into the sinking fund had been spent upon improving the property, the stockholders would eventually have received a larger dividend.

It may be assumed that the corporation can earn a higher return on money invested in improving its own property than the return on securities purchased for the sinking fund. Under these circumstances, it is a good policy to devote all surplus funds to increasing the earning power of the company, allowing the debt to run without a special provision for repayment. In other words, by refunding bonds when they mature, and by refusing to make any deductions from profits to provide funds for debt payment, a corporation not only pays a larger dividend but increases the value of its productive assets more rapidly than the value of its sinking fund would increase during an equal number of years. To put the matter in still another way, the accumulation of a sinking fund by a corporation decreases the proportion of debt to value of property less rapidly than when the annual amount of the sinking fund is invested in the equipment.[1]

For the larger corporations the sinking fund is usually in charge of a special trustee acting for the bondholders. With smaller corporations, however, it is customary to allow the sinking fund to remain in the custody of the corporation.

83. *Collateral trust bonds.*—With the growth of large holding companies a modified form of mortgage bond has come to be widely used. It is called a "collateral trust" bond because it is based on the securities of other companies owned by the bond-issuing corporation and deposited with a trustee as collateral security for the bondholders. The securities are covered by a deed of trust just as in the case of real property offered as security. The securities may consist either of stocks or of bonds of subsidiary companies or of a combination of both.

It would seem at first sight that a collateral trust bond would not be worth much, especially when the collateral

[1] *Trust Finance*, pp. 241-243.

consists of stock. In such a case the collateral trust bond would be junior by several degrees to all underlying bonds of the subsidiary companies. In case any of the subsidiary companies go into bankruptcy and force the holding company to default, all that the trustee for the collateral trust bondholders can do is to take the stock posted as collateral. When he gets the stock he still is a long distance from having tangible property with which to satisfy the demands of the bondholders. Even when the collateral consists of bonds they are usually junior issues and the collateral trust bondholders in case of default are very uncertain as to getting possession of real property.

Nevertheless, collateral trust bonds are sold at high prices. The Northern Pacific-Great Northern collateral trust 4's, which are secured by the deposit of Chicago, Burlington & Quincy Railroad Company stock, have steadily sold close to par. Many other similar issues are well thought of in the financial district. One reason is that the income, out of which interest on the collateral trust bonds is paid, is derived from the interest and dividends on the collateral, and these latter returns are more regular than are railroad or industrial profits. A second reason is that securities, if they are worth anything at all, are almost always readily salable, whereas real property, even if its cost and value are high, is apt to prove unmarketable. Hence, the collateral trust bonds have great advantages in these respects which in the eyes of the financial public often outweigh their obvious disadvantages.

Strange as it may seem, it is not impossible for a holding company with subsidiaries, whose credit is poor, to take the stocks and bonds of these companies, post them as collateral and sell the collateral trust bonds very

readily. It is not unnatural to feel a passing doubt as to the sanity of the financial world when one discovers that a promise to pay based on real property is less valuable than a promise to pay based on paper that is itself based on the same real property. Yet after all there is a sound reason for this apparent absurdity. Real property is hard to sell; paper representatives of property may be easily sold. Collateral trust bonds are therefore frequently excellent means of raising funds for subsidiary companies without much credit of their own.

They are also very useful at times in financing the process of buying control of subsidiary companies. The holding company borrows money from the banks and buys securities; then it issues collateral trust bonds based on these securities and with the funds thus obtained pays off the bank loans. Thus it finds itself with very little expenditure of its own funds in full control of the company whose stocks it has bought. Some companies have repeated this simple process time and time again. It is entirely legitimate, though somewhat risky.

To protect the bondholders, collateral trust mortgages generally provide against the issue of any securities by subsidiary companies ahead of those deposited as collateral. The mortgages also frequently have clauses to prevent unfavorable leases or other misuse of property represented by the deposited securities.

A further study of this type of bond belongs in the subject of investments rather than here. Enough has been said to indicate how a holding company may, by means of collateral trust bonds, borrow funds which it would probably be impossible for the subsidiary companies to reach.

84. *Equipment trust bonds.*—This form of bond is not used to any extent by other than railroad companies.

The equipment used as security for a bond issue of this kind does not belong to the railroad company at all. The manufacturers of the equipment usually turn it over to an intermediary company, which in turn leases it to the railroad, generally for a term of ten years or less, and hands over the lease to the trustee of the equipment trust bondholders. The railroad pays to the trustee the purchase price of the equipment in equal installments, together with interest on unpaid installments. When the payment is complete, the lease is cancelled and the title to the equipment passes to the railroad company.

In the meantime, in order to pay the manufacturers the intermediary company issues bonds to about 80 or 90 per cent of the cash value of the equipment. The bonds are in serial form so that as fast as purchase money is received from the railroad it may be devoted to their redemption, and the series is so arranged that when the last payment by the railroad is made the last bonds are redeemed.

The form of an equipment trust bond is given on page 187, and the following extract from the prospectus of one of the early intermediary companies in this field will further explain the working of this ingenious plan.

The business of the Railroad Equipment Company is to lease and conditionally sell on what is known as the Car Trust plan, to railroad and other corporations directly connected therewith, certain needed Rolling Stock.

A cash payment ranging from 10 per cent to as high even as 50 per cent is made at the outset, and the principal and interest of the balance due, represented by the promissory notes of the Corporation, maturing at fixed intervals over a term of years, is secured by a first lien or mortgage on the said Rolling Stock,

Series B132. $1,000 No. 0000.

THE RAILROAD EQUIPMENT COMPANY.

Special Car Trust Loan of $375,000.

New York, April 2nd,

For Value Received, The Railroad Equipment Company promises to pay to the bearer, or if this bond be registered, then to the registered holder hereof, One Thousand Dollars, on the First Day of April, 1896, with interest at the rate of Six per cent per annum, payable semi-annually, on the surrender of the coupons attached hereto, at the office of the Company in the City of New York, or E. W. Clark & Co., in the City of Philadelphia. This obligation is one of Series B132, bearing even date herewith, to the aggregate amount of $375,000 which are secured by a pledge or mortgage made by this Company to the Farmers' Loan and Trust Company, in trust, for the benefit of the holders of these obligations, of a lease of railroad equipment and rolling stock, under date of February 15th, 1888, made by this Company to the Atlantic and Pacific Railroad Company.

Said lease is hereby specifically pledged as security for the payment of the series of obligations of which this is one, when and as they shall be or become due and payable, and in the order of their respective maturities, according to the terms set out in the pledge or mortgage made by this Company to the Farmers' Loan and Trust Company.

After registration, this bond is transferable only on the book kept by this Company or by its agent for this purpose. Such transfer to be noted by endorsement on this bond.

On presentation of this bond for registration, the coupons thereon shall be cut off and cancelled by this Company, and interest on this bond shall be thereafter payable only to the registered holder thereof.

..................................*Treasurer.* ....*President.*

[On the back.]

Trustee's Certificate.—This obligation is one of Series B132, bearing date April 2nd, 1888, which are secured by a pledge or mortgage made by The Railroad Equipment Company to the Farmers' Loan and Trust Company, in trust for the benefit of the holders of the said obligations, amounting to Three Hundred and Seventy-five Thousand Dollars, of a Lease of Railroad Equipment and Rolling Stock under date of February 15th, 1888, made by the Railroad Equipment Company to the Atlantic and Pacific Railroad Company.

The Farmers' Loan and Trust Company,

by ....*President.*

New York, April 2nd, 1888.

Date of Registry.	In Whose Name Registered.	Transfer Agent.

[On the end, fifteen Coupons, dated each first day of April and October, from April, 1889, to October, 1896, the face of the first one reading:]

Coupon No. 1. Series B132. $30.—The Railroad Equipment Company will pay to bearer, on April 1st, 1889, at the Banking House of Post, Martin & Co., in the City of New York, or of E. W. Clark & Co., in the City of Philadelphia, Thirty Dollars, being six months' interest on Bond No. 0000.

H. A. V. Post, *Treasurer.*

the whole of which remains as such security until the last note is paid.

These deferred payments extend over a period ranging from four to ten years, and during such periods and until the final payment is made and all the provisions of the Car Trust Contract have been fully complied with, the conditional purchaser uses the Rolling Stock as *lessee* only, and subject to the legal rights of the lessor, in whom the title to the property remains fixed and inalienable and unaffected by any liens or indebtedness of any kind of the lessee.

The lessee is also bound by the contract to keep the Rolling Stock in proper repair, to replace it if destroyed, and to hold it at all times subject to the inspection (it being readily identified, not only by the road numbers, but by the ownership plates invariably attached to each locomotive or car) of the lessor, by whom and for whose benefit it is fully insured.

In case of default of any of the payments, or of non-performance of the other provisions of the contract, the lessor has the legal right, not only fully recognized and confirmed by the United States Courts, but also protected by direct legislation in many of the States, to take immediate possession of the Rolling Stock wherever it may be, or however in use, to sell it at public or private sale, and to apply the proceeds to the payment of any indebtedness arising under the contract, whether matured or not, and in cases where a Receiver is appointed, the rule of the Courts is to order him to pay the Car Trust notes as they mature, rather than lose the use of the Rolling Stock and the benefit of the payment already made on it.

The securities arising under these Car Trusts are assigned to a Trust Company, and are held by it in trust, as security for certain Bonds of The Railroad Equipment Company issued against the same.

The holder of these Bonds has therefore as his security:

The direct obligation of the Railroad Equipment Company.

The direct obligations maturing at specified dates, generally monthly or quarterly, of the Corporation, the lessee of the Rolling Stock.

The absolute ownership of such Rolling Stock which is kept in repair, insured, and replaced if destroyed, and the first cost of which, already reduced by the cash payment at the outset, is being steadily still further reduced by the periodical payment made by the lessee.

The security behind bonds of this character is excellent. In the first place, no railroad has ever yet defaulted on an equipment trust bond issue, because to do so would mean a loss of its equipment. All through the railroad receiverships of the 90's the receivers paid the interest and principal on these bonds regularly. In the second place, the railroad merely leases the equipment until the last payment is made and in case of default, therefore, no legal process is necessary in order to enable the trustee to take physical possession of the property. The leases usually provide that the equipment is to be kept in good repair.

In effect this form of security is a kind of chattel mortgage. From the railroad corporation standpoint it is open to the usual objection against chattel mortgages, namely, that it pledges a semi-fixed asset under a short term obligation which must be met at all hazards. It may well happen that the railroad, in order to meet this obligation, will have to part with funds necessary in order to meet other fixed charges. The best managed railroad corporations use these instruments with great caution. One reason for their existence is that many existing first and second mortgages on railroad property have what is called an "after-acquired property" clause, which makes the mortgage extend over all the property that the railroad owns at the time of making the mortgage and all that it acquires thereafter. Under this clause a straight mortgage on equipment would not

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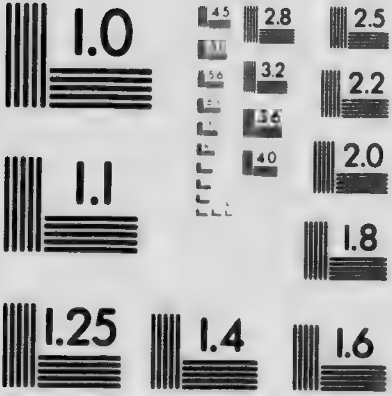


APPLIED IMAGE Inc
East Main Street
New York
Phone
Fax

be a first lien. The lease is the method by which this difficulty is overcome.

The market for equipment trust bonds is narrow, partly because the public does not thoroughly understand them and partly because the issues are relatively small. They are largely bought by banks, insurance companies and other financial institutions desiring to invest their reserve funds to the best advantage. The average yield on equipment trust bonds is considerably better than on ordinary mortgage bonds and their safety is almost perfect.

The principle of the equipment trust bonds is not applied to any considerable extent in industrial corporations and with very few exceptions it would be highly inadvisable for such corporations to buy equipment in this manner.

85. *Five-year equipment notes for Canadian railways.*—Some surprise was created in American and English financial circles in July, 1913, by the issue in London, by the Grand Trunk Railway of Canada, of £1,500,000 five year, five per cent secured notes, dated October 1, 1913, and due October 1, 1918. The notes were to be in denominations of £200 and £100, and could be registered as to principal only. The company reserved the right to redeem the notes at 101 either as a whole, or in amounts of not less than £200,000 by drawings on any interest date upon sixty days' notice; and in the event of any notes being redeemed before the date of maturity the trustee would release a proportionate part of the debenture stock deposited with them as security. The notes were secured by the deposit with the trustee of £2,000,000 Grand Trunk perpetual four per cent consolidated debenture stock. The issue price was 98, payable as follows:

Per Cent	On
£5	Application
£30	Allotment
£30	August 30th, 1913
£33	September 30th, 1913
£98	

According to a statement in the prospectus by Mr. A. W. Smithers, chairman of the Grand Trunk directorate, the proceeds of the notes were to be "applied in part payment for additional rolling-stock (75 engines and 8,000 freight cars), the contract price for which exceeds £2,000,000. This new equipment has become necessary owing to the approaching completion of the Grand Trunk Pacific Railway and to the very large increase in the traffic of the system—including the Grand Trunk Western, Detroit, Grand Haven and Milwaukee, and Canada and Atlantic Railways, but not including the Grand Trunk Pacific Railway."

It therefore looked like an issue of equipment notes, but Canadian financial authorities have not been inclined to class them as such, as the terms of payment and the periods are different from the standard equipment trust bond or note described in previous pages. About the same time the Grand Trunk Railway sold an issue of equipment notes in the United States. The five-year note issue in London must be considered as an ordinary short-term loan, and as such it created a considerable flutter in financial circles. One objection raised in London to borrowing on such onerous terms was that it tended to depreciate the value of the company's debenture stocks.

The company did get the money, as the issue was oversubscribed.

A cable message from London stated that the market there objected to the company embarking on a new form of financing by the issue of short-term notes, but that it was being pointed out that many of the first-class roads in the United States, such as the Lake Shore and the New York Central, had been recently doing the same thing and on no better terms than the Grand Trunk was able to obtain; in fact, in most cases the United States lines had to pay considerably higher rates than the Grand Trunk for temporary loans of this nature.

The short life of such securities as these Grand Trunk notes recommends them specially to a growing class of investor which confines itself to redeemable securities of this kind. It brings us, however, to the question of short-term loans generally, which is discussed elsewhere.

CHAPTER XI

TYPES OF CORPORATION BONDS (CONTINUED)

86. *Debenture bonds.*—There are two different uses of the word debenture which are somewhat confusing. In law any instrument which formally acknowledges a debt and promises payment, including any written bond secured or unsecured, is a debenture. In finance, however, the term has come to be restricted to a bond which is not secured by a lien upon any specific property. In other words, it is for all practical purposes, simply an unsecured promissory note running for a number of years. Being unsecured, the debenture bond, in case of insolvency, is legally on the same level as the general floating indebtedness of the insolvent corporation.

The debenture is much used in the financing of English corporations. Indeed, our American mortgage bond, in the case of railroads at least, is there almost unknown. It is used so largely because the English investors realize clearly that the earnings of the railroad after all are their actual security. As has already been pointed out, the holders of a railroad mortgage in case of foreclosure seldom take the physical property which legally belongs to them, because to separate any portion of a railroad's property from the rest is to diminish and perhaps destroy its value. Logically, therefore, the English custom is right and the American custom is wrong. In practice, however, it is probable that the American railroad managers have borrowed more funds on better terms than have the English railroad managers. An English railroad corporation has only cne

kind of bond—the simple debenture—to offer; an American railroad corporation may offer, as we have seen, an indefinite variety of mortgage bonds, each bond being secured by a lien on some part or section of the railroad property. The American junior bond, for that reason, looks better to the average investor than the English junior bond, and is more readily salable. Notice that this statement says "looks better," not "is better." If all American railroad mortgage bonds were to be exchanged for simple debentures arranged in the order of their priority, investors would be as well off as they are now.

Under the present system, however, the existing debenture bonds are for the most part far inferior in security and investment standing to mortgage bonds. Indeed, it would hardly be correct to call any of the present railroad debenture bonds, with a few notable exceptions, investments at all in the technical sense of that word, as previously defined.

If debenture bonds are so far inferior to mortgage bonds and therefore so much less attractive to investors, why issue them at all? There are several possible reasons. In the first place, a company may have reached its limit, so far as mortgage borrowings are concerned; it may have nothing of any great value left on which first and second mortgages have not already been placed. Third mortgages are so unpopular with investors that a simple debenture may be more easily sold.

Sometimes debenture bonds are created when a bankrupt railroad company is reorganized. The reorganizers may desire to lighten the load of mortgages that previously weighed down the company and perhaps caused its bankruptcy. In the general scaling down of

sider in detail when we take up reorganization—the junior mortgage issues are often replaced by debentures. This is the origin of most of our present railroad debentures.

A third possible reason may be that a conservative corporation is anxious to reserve some of its resources for future mortgage issues. Suppose a railroad, for instance, already has a first mortgage on all its property and desires to borrow a comparatively small additional sum. If it places a second mortgage on its property it will have used up much of its remaining borrowing capacity. If it issues simple debentures, however, it will still have a second mortgage to fall back upon. Usually debenture bonds issued under such circumstances are accompanied by an agreement between the corporation and the bondholders to the effect that if any new issue of mortgage bonds is subsequently put out, the debenture bondholders shall be secured by the same mortgage as the new bondholders.

A fourth reason that has at times led to the issue of debenture bonds is that they are intended to be sold to European investors, among whom, as has already been stated, such bonds are highly regarded. In the reorganization of the Wabash Railroad Company in 1887, for instance, certain issues which are actually secured as to principal by a third mortgage were nevertheless given the name of "debenture bonds, Series A," because they were intended for English investors.

In this country the most successful railroad debenture bond issues are those of the New England railroads, for the obvious reason that the earnings of these roads are not only large, but particularly stable. The Boston and Maine R. R. Co. has outstanding four mortgage bond issues and seven debenture issues. All of the de-

benture bond issues commanded good prices and were considered sound investments. The earnings of this company have averaged six or seven times interest charges. Similarly the New York, New Haven and Hartford R. R. Co. has six issues of debenture bonds outstanding in addition to numerous issues of mortgage bonds of subsidiary companies. The net earnings of this company have been more than three and one-half times the interest charges. The practice of issuing debenture bonds seems to be gradually gaining favor among American railroads, and a number of lines have adopted the policy of replacing mortgage issues when they mature by simple debenture issues. The debenture bond is not much used by industrial corporations, however. These corporations do not usually have the confidence of investors and the stability of earning power which are necessary to make debenture bond issues successful.

87. *Income bonds.*—The income bond is a hybrid, partaking of the nature of both bonds and stock. As the name implies, the payment of interest charges can be demanded only when there is sufficient income for that purpose; if the interest charges are not earned they need not be paid. The principal, however, is usually secured by a mortgage. If there is no such mortgage, as happens in one or two cases, the word bond is a misnomer. For all practical purposes such an "income bond," so-called, is preferred stock without voting power.

Income bonds are usually the product of reorganization and are designed to take the place of junior mortgage bond issues which it is thought necessary to scale. Their advantage lies in the fact that they do not impose any fixed interest charges on the corporation. However, there is a great disadvantage in the fact that the

principal is secured by mortgage and that therefore new mortgage bond issues in the future are hard to float. Another disadvantage is that there is apt to be dispute between the corporation and the bondholders as to whether the interest charges are actually earned or not. This objection can be obviated in part by inserting in the bond such a detailed statement of the method by which net income is to be determined as is given in the sample income bond shown on pages 146 and 147. The new system of railroad accounting under the Interstate Commerce Commission will probably aid in the settlement of this question in connection with railroad companies. For an example of the difficulties inherent in income bonds see the case of the Central of Georgia Railway Company cited in Chapter XXVII.

88. *Other types of bonds.*—The name of "participating bonds," is almost self-explanatory. A bond of this class usually gets a fixed rate of interest and in addition a share of whatever profits are earned by its underlying security. The best known issue of this kind was the Oregon Short Line participating 4's issued in 1903 and retired the next year, which were secured by all the stock of the Northern Securities Company, amounting to $82,-491,000 in the Oregon Short Line treasury. These bonds were to receive not only the regular 4 per cent but whatever dividends over 4 per cent were declared on the collateral stock.

Profit-sharing bonds, which are infrequently issued, usually entitle the bondholder to get back his principal with the agreed interest and also to share in whatever increase in the value of the underlying assets may take place before the retirement of the bonds.

Joint bonds are direct obligations of two or more cor-

$500 UNITED STATES OF AMERICA $500

ATCHISON, TOPEKA AND SANTA FE RAILROAD COMPANY.

No............ FIVE PER CENT INCOME GOLD BOND.

For Value Received, THE ATCHISON, TOPEKA AND SANTA FE RAILROAD COMPANY promises to pay to bearer, or in case of registration to the registered holder hereof, the sum of FIVE HUNDRED DOLLARS, on the first day of July, one thousand nine hundred and eighty-nine, together with interest thereon when earned at the rate of not exceeding five per centum per annum, payable only out of surplus net earnings, if any, on the first day of September, in the year 1890, and upon the same day in each year hereafter, on the presentation and surrender of the coupons annexed and to be annexed hereto, as they severally mature, both principal and interest being payable in gold coin of the United States of America, of the present standard of weight and fineness, or its equivalent, at the agencies of the said Atchison Company in the cities of Boston or New York, or at the office of Baring Brothers & Company, London, England. The principal of this bond is payable only after the principal and interest of all the General Mortgage four per cent Bonds of the Atchison, Topeka and Santa Fe Railroad Company, dated July first, 1889, shall have been previously paid in full. Interest upon the principal sum of this Income Bond, if any is earned in any year ending June thirtieth, shall be paid upon the first day of September following, at a rate not to exceed five per centum per annum, from and out of the surplus net earnings only of the mortgaged property, provided that in the judgment of the Board of Directors of the Atchison Company such surplus net earnings shall be sufficient in amount to justify payment of interest on this Income Bond, and such payment shall be by said Board of Directors authorized to be so made. Such interest shall not be cumulative, and each successive holder of this Income Bond accepts the same subject to the agreement that the Board of Directors of the Atchison Company shall in their absolute discretion determine what are the surplus net earnings, if any, in any year ending June thirtieth, and applicable to such payment of interest, by deducting from the amount of the gross earnings during said year all operating expenses of every kind, and all fixed charges, including rentals of leased lines and other property, interest of all kinds, and taxes of all companies whose stocks are directly or indirectly pledged or mortgaged hereunder, and after providing for and deducting the amount of the interest upon and the sinking fund requirements of all bonds or obligations of the Atchison Company, including the above described General Mortgage Bonds, and of all bonds or obligations of other companies, the payment of the principal or interest of which has been guaranteed or assumed in whole or in part by the said Atchison Company, and after providing for and deducting the cost of the maintenance, renewals, repairs and improvements of the railroad,

telegraph equipment, and appurtenances of the Atchison Company

telegraph equipment, and appurtenances of the Atchison Company, and of the railroads which at the date hereof or during the life of said Income Bonds may form a part of the railroad system of the Atchison Company. The Atchison Company may at any time at its pleasure redeem this bond at its face or par value by giving notice of said proposed redemption six months prior to the first day of September in any year by publication once a week for three successive weeks in any newspaper of general circulation published in each of the cities of Boston, New York and London; and interest upon this bond, when so called for redemption, shall cease on and after the first day of September following such publication. All the provisions of the said General Mortgage are hereby expressly declared to be part of this bond and of every coupon hereto attached. No recourse shall be had for the payment of the principal or interest of this bond to any stock holder, officer or director of said Atchison Company, either directly or through the said Atchison Company, by virtue of any statute or by the enforcement of any assessment or otherwise. All payments upon this bond of both principal and interest are to be made without deduction for any tax or taxes which said railroad company may be required to pay or to retain therefrom by any present or future laws of the United States of America, or any of the States and Territories thereof, said railroad company hereby covenanting and agreeing to pay any and all such tax or taxes. This bond is one of a series of Income Bonds, coupon and registered, of like tenor and date, the payment of which is secured by a General Mortgage or deed of trust, duly executed and delivered by the Atchison, Topeka and Santa Fe Railroad Company, the obligor, to the Union Trust Company of New York, Trustee, bearing date October fifteenth, 1889. This bond shall pass by delivery, or if registered, by transfer upon the transfer books of the Company. After registration of ownership, certified hereon by the transfer agent of the Company, the coupons shall remain negotiable; but no transfer of this bond, except on the books of the Company, shall be valid unless the last transfer is to bearer, which shall restore transferability by delivery, and it shall continue subject to successive registrations and transfers to bearer as aforesaid at the option of each holder; or the holder may, at any time, at his option, surrender this bond and the annexed coupons to the Company to be cancelled, and receive in exchange therefor a registered bond of the same issue, and thereafter it shall not be transferable to bearer, but the interest shall be paid to the registered holder. This bond shall be valid only when authenticated by the certificate hereon of the said Trustee, or its successor in said trust, that it is one of the Income Bonds issued under and described in the said indenture of trust or general mortgage.

In Witness whereof, The said Atchison Company has caused its corporate seal to be hereto affixed and these presents to be signed by its Comptroller or a Deputy Comptroller, and attested by an Assistant Treasurer, on this first day of July, 1889.

Atchison, Topeka and Santa Fe Railroad Company,

Attest............................*Assistant Treasurer.* By............................*Comptroller.*

No. .... $ ....

NEW YORK, WEST SHORE AND BUFFALO RAILWAY COMPANY.

Receivers' Certificate of Indebtedness.

This is to certify, that the bearer hereof is entitled to receive from Horace Russell and Theodore Houston, and their successors, as Receivers of the property of the New York, West Shore and Buffalo Railway Company, covered by the first mortgage to the United States Trust Company of New York, as Trustees, but not personally, the sum of .... dollars, upon the production hereof, and endorsement hereon of such payments on or before the first day of July, 1887, at the office of said Receivers in the City of New York, and interest thereon from the date hereof, at the rate of six per centum per annum, payable on the first days of each January and July, unless said sum and interest thereon, as aforesaid, be sooner paid by the Receivers out of the moneys coming into their hands from time to time, applicable thereto, or the moneys realized by them upon the sale of the mortgaged property in their hands. This Certificate is one of a series of certificates, amounting in the aggregate to a sum not to exceed five million dollars, and issued or to be issued under the authority and by virtue of the order of the Supreme Court of the State of New York, and under the authority and by virtue of the order of the Circuit Court of the United States for the District of New Jersey, in equity, and for the purposes and objects therein mentioned, said orders being made on the .... days of June, 1884, respectively in actions in said courts, wherein United States Trust Company of New York is plaintiff and complainant, and said railway company is defendant. Said certificates to the amount secured thereby are hereby declared to be a debt of the Receivers incurred for the benefit and protection of the mortgaged property in their hands, and until full payment thereof, to be a lien and charge thereon prior to the first mortgage and the interest thereon. This Certificate is not valid until countersigned by Franklin E. Worcester, Treasurer of the Receivers.

In witness whereof, we, as Receivers aforesaid, but not personally, have signed this Certificate this .... day of ...., one thousand eight hundred and eighty-

porations which join in issuing them. A well-known example is the Northern Pacific-Great Northern issue of joint collateral trust 4's. Somewhat the same effect is gained when a holding company guarantees a subsidiary company bond issue.

A corporate security which should be mentioned here, although it is not, strictly speaking, a bond, is a receivers' certificate. This represents money expended by the receivers of an insolvent corporation under authority of the court, as shown in the sample given on page 148. They constitute a claim on the property of the corporation superior to all other claims whatever. They go ahead of the first mortgage bonds. They do not, of course, usually exist in large quantities and a reorganized corporation will endeavor to refund and pay them off as quickly as possible. It is well to bear in mind, however, that in the case of an insolvent corporation this kind of security may be used as a last resort when funds could hardly be secured in any other manner.

89. *Purposes, manner of payment, and conditions of redemption of bonds.*—The descriptive words applied to bonds indicating their purposes are almost all self-explanatory. "Unifying," "refunding," "adjustment" and "consolidated" imply that the previous bond issues are to be retired or rearranged in some way. "Construction," "improvement" and "extension" show that the funds secured from the bond issue are to be expended in some kind of development. "Purchase-money" bonds are sold before the property on which they are based is actually bought. Usually the funds secured by the sale of the bonds are turned over to a trustee to be held until certain specific property is purchased. Then the funds are paid out by the trustee and he receives in return a first mortgage on the property.

A registered bond is issued to an individual in the same manner as a certificate of stock and ownership can be transferred only on the books of the company. Interest is paid by checks which are sent out to the registered owner. Coupon bonds are usually payable to bearer and interest payments are represented by coupons attached to the bond, as indicated in the bond forms given on pages 151 and 165. When the interest date approaches, the coupon is detached from the bond and deposited in a bank just as a check on the corporation would be deposited. In fact, the coupons are practically simply post-dated checks. Sometimes coupon bonds are registered as to principal, in which case transfer of ownership is not made simply by delivery, but must pass through the books of the company. The interest coupons, however, are payable to bearer. Frequently an issue of bonds may be either coupon or registered at the option of the buyers.

There are obvious advantages in each form. The coupon form is very convenient, inasmuch as it may readily be sold or hypothecated. The registered form makes up in safety what it lacks in convenience. If it is lost or stolen it can be negotiated only by a forgery of the signature of the person in whose name it stands, in which case the transfer would not be valid. When a coupon bond is lost or stolen and is once sold to an innocent purchaser for value, the original owner must stand the loss.

A gold bond is one which specifies that payment of principal and interest shall be made in gold coin. If there is no such provision it is understood that legal tender will be acceptable. There have been times in the history of the United States, notably during the periods of greenback inflation and of free silver agita-

tion, when this gold coin provision was regarded as highly important. At present not a great deal of attention is given to it.

Redeemable bonds are those which may be redeemed at the option of the corporation before date of maturity. Sometimes the selection of the particular bonds to be redeemed is made by lot and the terms of redemption are made attractive with a view to appealing to investors with a speculative twist of mind. The wisdom of issuing redeemable bonds is questionable. It introduces an element of chance which makes it very difficult to figure mathematically their exact value and which probably tends to depress their market price.

Serial bonds are redeemable in series extending over a term of years.

90. *Convertible bonds.*—This is a type of security that was revived a number of years ago, and has since become increasingly popular. It may be changed or converted under certain conditions into some other kind of security—usually into stock. The privilege of conversion may belong to any kind of bond, mortgage, debenture, collateral trust or income. The usual arrangement is to permit a mortgage bond to be exchanged for preferred stock of the issuing corporation at a prescribed rate of exchange and within a certain definite period.

For instance, the Union Pacific Railroad issued in 1901, $100,000,000, of 4 per cent bonds which were convertible into common stock at par. As Union Pacific common sold in 1907 and 1908 at an average price much higher than par, practically all of this issue was converted long before the expiration of the time limit set.

The advantage of this scheme is that it gives bonds a speculative, in addition to their investment, value. The

buyer figures that he gets as safe an investment security as he would have if there were no such privilege and in addition he may share, if he chooses, in any great upward movement of the stock. The privilege of convertibility enables the company to borrow at a lower rate of interest. A further advantage, from the corporation's standpoint, is that the company if successful may expect to be relieved by the process of conversion of the payment of interest on the bonds. Thus room will be made for additional future issues of bonds, if such issues are regarded as necessary.

From the investor's point of view the advantages of convertible bonds are summed up in a circular by Mr. Henry Hall issued in March, 1909. Notice that this circular recommends the bonds to the semi-investing rather than to the strictly investing public.

Convertible bonds belong to the sounder class of speculative investments, combining a reasonable degree of safety and certainty of interest return, with possibilities of substantial enhancement in value. Investors make from 25 to 50 per cent profit, sometimes more, on convertible bonds when properly bought.

Convertible bonds were first issued in this country forty and fifty years ago, when the financing of even the most promising of American railroads and at a high rate of interest was a difficult matter, and when it was occasionally necessary to offer special inducements to ensure the success of a new loan. Most of the financing of St. Paul, for instance, for twenty years or more after 1860, was accomplished through the issue of this class of bonds. It is said that as late as 1896, there were yet outstanding twelve separate convertible issues of the St. Paul. From 1880 to 1900, few or no issues of convertibles were made; but the requirements of the railroads then became so imperative and the multiplicity of competing issues became so great, that in 1900 and 1901 the convertible idea was once more resorted to.

In a general way, convertible bonds tend always to follow the price of the stock for which they are exchanged. This tendency is clearly exhibited by the quotations in this circular. Their fluctuations in price are therefore more lively than those of staid first mortgage and other strong issues. An ordinary bond of good standing seldom moves more than 5 to 10 points from year to year, while convertibles are apt to fluctuate from 10 to 30 points in a single twelve months. The Erie 4s, Series A, fell from 109⅞ in one year to 46½ in the next and then rose to 80½.

Convertible bonds are always a direct obligation of the company. Some of these issues are secured by mortgage. Others are not, but this latter fact does not necessarily impair their value. It merely suggests a careful scrutiny of general conditions and the business of the company before buying them.

Of course there are corresponding disadvantages. The stockholder may well say that if the company is going to be successful it would be far better to let the bonds stand and thus save more of the income for the stockholders. On the other hand, if the company is not successful, the bonds will not be converted into stock. The stockholder sees loss for himself in either alternative. This would perhaps be an unanswerable argument, if it were not for the fact that the bonds are almost always offered at less than market prices to stockholders, so that the holders of convertible bonds and the holders of stock are likely to be the same persons; or at least the stockholder gets a valuable privilege in the form of a right to subscribe to the bond issues.'

CHAPTER XII

CORPORATE PROMOTION—THE NEW ENTERPRISE

91. *The function of a promoter.*—A promoter is a man who organizes a new business and sets it going. The business need not necessarily take the form of a corporation. It may be handled as a partnership or a joint stock company. As new enterprises at the present time, if of any magnitude, are almost always conducted by corporations, however, it will be convenient and not far from the truth to speak as if the work of a promoter were confined to organizing and financing corporations.

The promoter is necessary because the great mass of the funds used in large corporate enterprises is passive; that is to say, the owners of investment funds are not primarily engaged in buying and handling business enterprises. They wait until a good proposition is presented to them. The function of the promoter, therefore, is to bring his proposition to the attention of the owners of funds in such a manner as to arouse their interest and confidence and induce them to buy the securities of his new corporation.

The word promotion has a tinge of discredit attached to it, partly because the promoter, from the very nature of his work, is apt to be over-sanguine and a little careless as to exact accuracy, and partly because the high-sounding word promotion is used by many swindlers who prey upon ignorant and foolish speculators.

One of these last mentioned gentry describes his operations in the following words:

Today THE PROMOTER—the 20th Century genii—takes an existent business enterprise, and, for every five dollars it *annually* earns, gives it *immediately* ninety-five dollars. He takes an Opportunity—an intangible, impalpable thing—and from it creates an *actuality*, a vigorous growing enterprise that showers wealth and happiness on thousands. He takes apparently irreconcilable interests, waves his promotion wand above them, and presto! they become associated by the bands of common interest, loyal to a single standard. Over business men he throws a mantle that protects their private means against bankruptcy, litigation or ruin. He carries a veritable Aladdin's Lamp—the Lamp of Knowledge, the Lamp of Power, through which he conjures opportunities into actualities, small businesses into large. His powers, legitimately employed, upbuild industry. Literally, in service to humanity, he stands with powers as beneficent as those exhibited by the Good Genii of our childhood tales.

The end of this quotation, when applied to men whose sole object is to draw into their own pockets as much as they can of the savings of their credulous victims, is sufficiently absurd. But when it is restricted to the true promoter, a man whose judgment and business instincts are sound and whose persuasive powers are used to secure funds for a legitimate business enterprise, the statements are not at all exaggerated. The promoter does, in fact, perform highly important tasks and often richly deserves the great rewards which fall to his share. Many of the great business men of America are promoters—though, as noted in the next chapter, such men do not usually spend all, or even most, of their energies in promotion. To this class belonged the men who between 1900 and 1907 formed great industrial "trusts," including H. H. Rogers, John W. Gates, D. G. Reid, W. H. Moore. Closely allied with them were finan-

ciers like J. P. Morgan, E. H. Harriman, George F. Baker and James Stillman.

92. *"Discovery" of a proposition.*—A promoter in handling an enterprise has three separate tasks before him. First, he must "discover" his proposition; second, he must "assemble" it; third, he must "finance" it.

The discovery of a proposition does not mean simply to find it, but includes a thorough investigation into all the surrounding conditions, and the solution in advance of all the difficult problems that are likely to arise in its development. Let us suppose, for instance, that a new invention which looks good on the surface is brought to the attention of a promoter. If he understands his business he will first of all examine critically every factor that points toward the invention's success or failure. He will find out whether it is patented and just what features the patent covers. If it is not patented, he will make sure, through a competent patent attorney, that the device is actually new and patentable. If he is prudent he will probably instruct the attorney to find out whether any similar invention is used in foreign countries or not. Next, he will consider whether other devices are in use which perhaps accomplish the same purpose as well or nearly as well as the invention. After making sure that the invention is what it purports to be, he will consider the possible markets for the article. The invention may be a new machine that could be used in only a few concerns, and perhaps these concerns would prefer to retain their present machines rather than expend any great amount of money for something new. In this connection the promoter will have to find out whether any incidental expenses are necessary in connection with the use of the invention. Generally speaking, the slighter the change from current methods,

the more readily the invention may be marketed. The amount of advertising and selling expense called for must also be taken into account.

Next, the promoter takes up the cost of manufacturing. He finds out whether new and specially constructed machinery is necessary in manufacturing the invention, and whether any especial skill on the part of laborers is required. He considers the amount of experiment that will be necessary in order to perfect the invention and in addition figures a large amount of extra cost for unforeseen contingencies.

These are only a few of the factors that the promoter would investigate before taking any further action. Their number is sufficient to indicate, however, that any promoter who has a reputation to make or preserve, cannot afford to jump hastily at whatever proposition is presented to him. The process of discovery may take a long time, perhaps months or even years.

The case just cited is comparatively simple. Where a promoter is dealing with such an enterprise as a new railroad or a new mine or with a consolidation of manufacturing plants, he is confronted by a far more complicated situation. If the investigation is thorough and searching, the promoter will be able to give a well-grounded and satisfactory answer to every question that prospective buyers may raise.

93. *"Assembling" a proposition.*—By assembling a proposition is meant the process of getting temporary control into the hands of the promoter. If he is dealing with an invention, he assembles the proposition by getting an option on the invention or by making an agreement with the inventor on a royalty basis. In the case of a consolidation of plants or railroads into a new corporation, assembling is frequently much more compli-

cated and difficult. In such a case the promoter may have to get options or arrange the terms of purchase with every plant and perhaps with all the different classes of security-holders involved. Unless a promoter has these agreements or options in his own hands, it is as a rule foolish for him to go ahead with any further efforts. He might complete his arrangements for putting the new corporation on its feet and then find that in the meantime the original owners of the property had sold to other parties or had taken steps that would diminish the value of the property. Or he might find that after forming the corporation and bringing the owners of the funds and the owners of the property together, they would mutually agree to dispense with his services and would leave him, so far as his compensation is concerned, out in the cold.

94. *Financing a proposition.—The initial development.*—Now we come to the most difficult part of the promoter's work, his financing of the new corporation. No hard and fast rules can be laid down to cover the promoter's procedure. There are some general principles, however, which apply to all enterprises and which should always be kept in mind.

First, it is advisable in practically every case to develop the proposition as far as possible with the promoter's own resources and those of his immediate friends before it is presented to outsiders. In making this statement it is assumed, of course, that the promoter really has faith in his proposition and is willing to take whatever risk is involved in developing it; otherwise the promoter will naturally spend as little as possible of his own money. In the case of an invention, for instance, which the promoter is trying to finance, it is far better to have the invention actually manufactured and a few

of the articles on exhibition before any attempt is made to interest outside capital. If this is impossible, a working model at least should be on hand. The average capitalist is not likely to part with his money unless he sees before him something more tangible and impressive than a verbal description of what the inventor expects his as yet unborn machine to accomplish.

If a promoter is financing, let us say, a copper mine, he should do his utmost to have the ore bodies opened up and mining operations started, even if only on a small scale, before he starts to float his corporation. Where the promoter is consolidating several existing plants he already has some of his exhibits at hand in the form of the going plants and companies that are to be consolidated. Nevertheless, the combination itself is in reality a new enterprise and the promoter should spare no pains to secure some practical demonstration of its profit-making possibilities. Sometimes he may point to the success of previous combinations created under closely similar conditions. If he does not have examples, at least he can get exact figures as to the selling, administrative and operating expense under the present arrangement which would be saved if the combination were effected.

In general the promoter must bear in mind that an enterprise which exists only on paper does not make anything like as powerful an appeal to the buyer of securities as an enterprise which has something tangible to show. It may be that the standing and prospects of the enterprise are in reality very little changed simply by producing some tangible results. Nevertheless, the confidence of people with funds is much increased and this, after all, is the promoter's main object.

95. *Foresight in providing funds.*—Second, the promoter should take care not to get his enterprise into such a condition that funds must be secured immediately on whatever terms are demanded. This is a situation that is quite apt to confront one who goes ahead with construction and development too rapidly. In his eagerness to make a favorable showing he may perhaps run short of funds, find the obligations of his corporation pressing and be compelled to make some very disadvantageous deals or see his corporation go into bankruptcy. Many a meritorious enterprise has suffered this fate.

To prevent such a catastrophe the promoter should see that his corporation is capitalized for a larger amount than he expects to need; thus there will always be unused securities which may be offered for sale without involving tedious and unnecessary formalities. It may be well to have this stock actually issued and transferred to the treasurer of the company in the manner which has been previously described.

Furthermore, the promoter should endeavor to raise in advance of any expensive construction or development all the funds that will be required for that purpose. The corporation which has a factory half-built, or mining machinery partially installed, or merchandise business half-stocked, is in an extremely precarious condition. Without additional funds it can go neither backward nor forward. It has no valuable assets or established trade on which to borrow funds, it has no trade credit, it has no record of sales and profits to present to prospective buyers of securities. It is therefore unable to secure any funds except from some individual or small group who may come to its rescue. The promoter may feel reasonably confident that their assistance

will be purchased only with the sacrifice of his own control and probably of most of his profits.

96. *Advantages of a wide distribution of stock.*—Third, it is usually far better both for himself and for the corporation that the promoter sell his securities to a large number of small buyers rather than to a small number of large buyers. In the former case the stockholders are scattered and their holdings are too small to induce them to take any active interest in the business. Consequently the promoter, even if he fails to retain a majority of the voting stock, is left in absolute control. In the second case, the promoter is watched and perhaps hampered by the large stockholders; even if he holds a majority of the voting stock, he will probably not desire to arouse their objections and will therefore feel obligated to consult them or their representatives. Such an arrangement the promoter who has faith in his own abilities and ideas does not desire. He usually feels that he understands the proposition better than anyone else and that to him should be left the conduct of the business until it is well started toward success.

From the standpoint of the corporation, a large number of small stockholders is almost always desirable. The wider the distribution of the stock, the more friends the corporation has and the easier, probably, will be the selling of additional securities. Besides, the large capitalists who might be interested in the enterprise, should generally be kept in reserve for such emergencies as have been described. If the corporation does get into difficulties, in spite of all the care that its promoter may take, it can then turn as a last resort to these capitalists instead of drifting helplessly into insolvency.

97. *"Starting right" in the sale of stock.*—Fourth, if

the promoter is handling a legitimate small enterprise, he should look for his funds to the people of the locality where the enterprise is started. If the enterprise is too large for them, at least he should accomplish his preliminary financing—that is, the raising of sufficient funds to get the enterprise started, although not enough to carry it on to success—among the local people. Conservative bankers and business men always recognize the superior opportunities for getting exact information of local investors and have considerable confidence in their judgment. It is a great advantage to a promoter in presenting his enterprise to the public to be able to say that a large part of the funds have been subscribed by persons who are on the ground and in close touch with what is actually being accomplished. The same observations apply to people with technical training if the enterprise has many difficult technical features. The promoter of a corporation to manufacture a new electrical engine, for instance, ought to have the support of experts in that field—manifested not only in words, but by money—before he starts his campaign for subscriptions among outsiders.

98. *A concrete illustration.*—The practical application of the principles here laid down in the promotion and financing of interurban electric railroads has been well described in a lecture before the students of New York University School of Commerce, Accounts and Finance by Dr. Thomas Conway, Jr., of the University of Pennsylvania. Dr. Conway said:

The proposition having been discovered and thoroughly investigated, and the necessary options, for example the rights of way, etc., together with the necessary franchises, having been obtained, the promoter arranges to present the proposition to those who will furnish the money necessary. He accom-

panies his statement of anticipated earnings, with a map of the territory showing population adjacent and tributary to his proposed lines and he submits also engineers' estimates of cost of construction and cost of operation based on the amount of traffic, and the grades and curves which will be encountered. He is now ready to arrange for the financing of his proposition. His first step is to organize a corporation, usually under the laws of a state in which his road expects to operate. This corporation will be organized with the minimum capital permitted by laws of the state in order to save initial taxes payable to the state. It will be organized with a minimum amount of cash payment and, if possible, requirements for actual contributions, will be satisfied by turning in options to the company. The charter of the company contains the authorization of the amount of capital which will be required to finance the enterprise. This capital consists of bonds, preferred and common stock. It is important that the amount of bonds per mile of road should be kept down to the lowest practicable figure as a large bonded debt immediately arouses a suspicion and suggests the advisability of a more skeptical and scrutinizing investigation of the promoter's representations. The amount usually fixed upon as conservative is $20,000 per mile. This may be exceeded in cases of especially expensive construction where interest on an excessive amount may be offset by lower cost of maintenance.

The preferred stock issue is usually for subscription in the immediate locality where interest in the new proposition must be aroused. It is advantageous to secure the largest possible amount in this manner, since it gets down the amount of bonds to be sold and makes their sale correspondingly easy. Two courses of action are now open to the promoter. He may either, after securing the proper introductions, address himself to a private banker in some financial center and offer to him the entire bond issue, or he may arrange for the financing of his enterprise in his own locality, approaching the city banker only after he has a record of earnings upon which to base his argument.

The investo to whom these securities must be sold, will not

buy the bonds of an enterprise which has no recognized status, so long as it remains in formation and in chaotic condition. It is in his eyes a speculation and as such he is reluctant to put his money into its securities. If the bonds are, therefore, sold in the city, to the city banker, he must borrow the money to build the road, and must hold the bonds until at least a year's operation of the new property has been completed. The city banker will demand hard terms as a condition of advancing this money, if indeed one can be found with sufficient confidence in the new enterprise to risk his capital in its inauguration.

It is better, therefore, if possible, that the promoter should arrange for a preliminary financing of his scheme among local interests. This he does in the first place by securing subscriptions to preferred stock as already indicated. He also obtains a guarantee of purchase of the bonds of his corporation from local interests, bankers, institutions and capitalists, with whom he is acquainted, the condition of the guarantee being, that if the bonds are not sold within a definite time, say three years, above the price named in the contract of guarantee, the guarantors will take them at that price. The city banker would usually require that local interests guarantee at least a portion of the bonds, and it is therefore just as well for a promoter if he can accomplish this to secure guarantee of the entire issue. In order to make the stock of his company fully paid a device frequently resorted to is that of a construction company organized by the promoter and his friends and associates, who receive all the stock except what preferred stock may be prescribed for bonds of the new company in exchange for an agreement to construct and equip its lines in accordance with the plans and specifications of the engineers, which are made part of the agreement. At the time this contract is executed, all the common stock and sometimes such a portion of the preferred as may not have been provided for is turned over to the construction company, together with a small amount of the bonds. The remainder of the bonds are issued to a trust company, which acts as trustee for the holders, in installments correspond-

ing to the completion of sections of the lines as certified to by the engineers representing the trust company. The promoter or his representative, acting for the construction company, which has now come into possession of all the securities of the new corporation, arranges with some trust company or bank to advance sufficient funds to build and complete the line. The security offered is the bond issue of the railroad company supplemented by the guarantees above mentioned and by a certain amount of the stock. The common stock of the railroad company, it should be mentioned, is divided up among the guarantors of the bonds. The trust company advances the funds, the banker finally sells the bonds, and what remains constitutes the promoter's profit. The amount of common stock, which must be given to each one of those interests, and that can be retained by the promoter, varies with circumstances. In return for making the loan, the trust company usually exacts a commission of say 2½ per cent to 5 per cent, besides the regular interest of 6 per cent or in some cases as high as 8 per cent, the loans running for two years. This money is advanced on serial notes of the construction company, corresponding to the completion of different sections of the road, and secured by the bonds which are issued to the construction company by their trustee as fast as the road is completed.

For example, we will suppose that the total amount of bonds is $1,000,000, and that these should be issued in ten installments to the construction company. The first installment of $100,000 is issued at the time the contract with the railroad company is executed. The construction company takes this note together with the guarantee of the purchase of these bonds, and $100,000 of bonds, and borrows from the trust company $100,000. With this $100,000 it pays for the completion of five miles of road. When it is certified to the trustee of the bonds that this mileage has been completed, another $100,000 of bonds is issued, another note negotiated and in this way by serial installments and notes, the trust company in time advances all the funds necessary to build the line. Prior to the completion of the lines

some portion of the interest may be earned by the sections which may be put into operation. It is customary, however, to provide in the original capital issue sufficient funds for the payment of one or two years' interest.

If the calculations of the promoter have been correct, after the company has completed its first full year of operations, little difficulty will be experienced in arranging for an advantageous sale of the bonds to the city banker. Some stock may be demanded along with these bonds, but the amount will be small compared with what would have been asked if the banker had been obliged to advance the money for construction. In agreeing to take the bonds of an interurban electric railway the banker is running little risk, and is often able to dispose of all the bonds as soon as he has completed his payments for them. These bonds, until the notes which have been secured have been paid, remain in the custody of the trust company which advances the money to the construction company as fast as the bonds are delivered to the banker. He makes payment for them, and with these funds the notes of the construction company are satisfied and all the bonds have been taken up and paid for; the indebtedness of the construction company is discharged, and there remains in its hands a certain amount of cash and securities which are distributed to its stockholders. The construction company's work having been accomplished, it is then dissolved.

CHAPTER XIII

THE PROMOTER AND THE CORPORATION

99. *Professional promoters.*—It is time to say something about the promoter, his personality, his duties, his legal responsibilities, the services that he performs and the pay that he receives. Readers who are unfamiliar with the world of finance may have assumed from what has been said that a certain class or group of men make it their sole business to promote enterprises and that no one else ventures into this field. This would be an entirely erroneous impression. Anyone who is pushing a money-making scheme is a promoter for the time being, or at least he is performing some of the functions of a promoter. On the other hand, as not everyone by any means is well fitted by temperament, training or practice to make a success of the difficult work of promotion, comparatively few men are concerned with such work to any great extent.

We may classify the men who spend a considerable amount of their time and energy in promotion into four groups. Let it be clearly understood, however, that this classification does not pretend to be complete.

First come the professional promoters, the men who really do make it their main, and almost their sole, business to hunt for enterprises that promise profits and to finance those enterprises. This type is common in fiction, but rare in real life. So far as the writer recalls, he has met only one man who could be put in this class,

a tall, lank, fervent individual with a persuasive air. At the time the writer knew him he was engaged in selling the stock of a Mexican rubber plantation company; he was also interested with others in the development of a tract of real estate near New York City; and he was investigating the possibilities of a copper mine in North Carolina. No doubt other plans were germinating in his mind. He was of the enthusiastic, visionary type, utterly incompetent to manage an enterprise but skillful in appealing to the aspirations and emotions of others. On the whole, he was fairly successful; that is to say, he was making enough money on one enterprise to pay his losses on the others and to get a decent living in the bargain. He was unquestionably honest in his convictions; indeed, it was easy for him to be honest, for he possessed a mind that readily believed whatever he wished to believe. Probably he was used as a tool in many cases, although he never suspected it, by shrewder and less scrupulous men.

It might be said that Mr. John W. Gates, Judge W. H. Moore, Mr. Daniel G. Reid, and the others named in Chapter XII, are professional promoters. It would be more nearly correct, however, in the writer's opinion to classify these men as primarily brokers, or lawyers, or bankers, who have won a few great successes in the field of promotion. The man who does nothing, but "promote" is not apt to achieve marked successes, one reason being that the really great opportunities are not usually stumbled upon by chance or disclosed to those who seek after them, but are revealed only to those who have an intimate acquaintance with the details of the business to be promoted. The only exception to this statement worth noting is when one who has already achieved success as a promoter is called in by men who

thoroughly understand the business to be promoted and who place their knowledge at his disposal.

100. *Lawyers and bankers as promoters.*—The second class consist of lawyers and bankers in small communities. Such men have exceptional opportunities to inform themselves as to local conditions; they frequently take hold of some local enterprise, such as a steam or street railway, secure the assistance of experts for investigation and carry through the proposition to success. Still more frequently, however, so far as the writer has observed, such men underestimate the difficulties of the problem; they take it up with enthusiasm but are forced either to drop it or to call in men of wider experience.

The men to whom they generally turn constitute the third class of promoters, namely the larger bankers and brokers. The amount of promotion work performed by such men is limited and they usually confine their active participation—except for advice—to the financing of such enterprises as they take up. The late Mr. J. Pierpont Morgan stood out as the most prominent example of this class.

101. *Engineering firms as promoters.*—The fourth class—and this is a recent important development—consist of engineering firms engaged in construction work of various kinds. Certain large engineering concerns have established a wide reputation for success in operating street railroads, water works, electric lighting plants, and so on. These firms naturally have built up a large and well-equipped staff of experts in those fields. As the staff is expensive, it becomes a pressing problem to keep them profitably employed all the time. In the effort to solve this problem such firms have drifted into the custom of taking up new enterprises of merit

and performing the work of promotion themselves. Their prime object in so doing is to employ their own engineering talents and the abilities of their staff to the best advantage. Incidentally, of course, they have no objection to securing some of the other returns that naturally follow from successful promotion.

These engineering promoters have three great advantages which have told heavily in their favor:

(1) They are able to carry on a thorough investigation of any project that is presented to them without much extra expense; and as they are constantly engaged in such investigations, they have developed a body of experts who are able to give the best possible judgment as to the outlook for success in each instance. Consequently they seldom go wrong.

(2) They are almost invariably big enough and have resources enough to finance the projects which they undertake themselves, if necessary. However, as they are primarily engineers, not financiers, they nearly always prefer to secure the greater part of the funds from other persons. This they accomplish by calling to their assistance some large banking and brokerage house, which will undertake to sell the securities of the corporations organized by the engineering firms. The alliance thus formed is of great advantage to the banking house, inasmuch as it may accept with confidence the results of the investigation carried on by the engineering firm's experts.

(3) The engineering firm, having a reputation to acquire and sustain, does not desert the new enterprise as soon as financed, as most promoters do, but sticks with it until it is a thoroughly established success. The engineering firm must have on its staff experts, not only in planning and building the street railroad or power

plant or whatever the new project may be, but also in operating the enterprise. It is in position, therefore, not merely to put the new corporation on its feet, but to give it a good running start toward success. Furthermore, if the corporation later gets into difficulties, the engineering firm may be relied upon to come to its assistance.

With these advantages there is no telling how far the tendency toward promotion by engineering firms will go. It would not surprise the writer to see almost all business of this kind except the large projects turned over by common consent within the next few years to the well-established engineering firms. No doubt, as soon as this tendency becomes well known, cheap imitators of the reliable engineering concerns will come into the field. This difficulty, however, can be overcome, and in the end we shall perhaps find the business of promotion cleaner, more reputable and conducted with greater ability than under present conditions.

102. *Secret profits are illegal.*—No mattter who the promoter of any particular enterprise may be, it is always necessary for him to raise funds from outsiders for his new corporation; and in the process of raising funds he must make representations as to the standing and prospects of the corporation. He also frequently enters into contracts on behalf of the corporation to be. His activities in both directions frequently raise knotty legal questions, which it is important for us to notice.

At law a promoter is in an anomalous situation, so far as his relation to his corporation is concerned. He is not, strictly speaking, an agent, because an agent must have a principal and the company promoted cannot be a principal because it is not yet in existence;

yet the courts have held that his activities in many respects are analogous to those of an agent. In addition, a promoter is in a sense a trustee of the interests of the corporation that he is organizing. He is under obligations to do his best for the corporation and to act always in good faith for its benefit. Furthermore, he must disclose all the pertinent facts in connection with the contracts and bargains that he makes for the corporation to its officers and stockholders when formed. Generally speaking, secret profits and fraud on the part of the promoter are not merely immoral, but are regarded by the courts as illegal as well. Where such transactions are discovered the corporation may bring suit and recover damages. Thus four cases given in abstract below illustrate different phases of this principle.

1. B agreed to sell land to X and Y, promoters of a corporation, for $12,000. He then associated himself with them and the three agreed to form a corporation which should buy the land for $40,000, out of which B was to receive the $12,000 he had originally demanded and in addition one-third of the profits of promotion. The company was formed. the purchase price of $40,000 paid and the stock of the company sold to outsiders. Subsequently the facts were discovered and the company filed a bill against the administrator of B's estate for the funds which B had received over and above $12,000, the ground of action being that B, as a promoter, was not entitled to make a profit by a sale of his land to the company at a fictitious value. The Supreme Court of Pennsylvania ordered a refund to the company of the amount received above $12,000.

2. B and C with the object of incorporating a mining company purchased oil lands for $10,000, and united

in organizing a company to buy the lands for $81,000. It was represented to prospective shareholders that B and C had purchased in the interest of the company and that the price paid by the company was the same as that paid by B and C to the original owners. The corporation sued B and C to recover the difference between the price paid in the first instance, and the figure at which the property was turned over to the corporation, and the suit was successful.

3. In a recent New York case it was shown that a promoter joined with the owner of a tract of land in procuring options of doubtful validity on adjoining tracts. The promoter then organized a corporation to purchase the land at an advanced price under an agreement with the owner that the profits thus secured were to be shared equally. The promoter bought the land for $66,223, though the deed to him recited $80,000 as the purchase price, and conveyed the land to the corporation for $80,000 and 400 shares of stock. He sold the stock to other stockholders and kept for himself the $13,777 profit. All of the money paid to the original owners of the land belonged to the corporation. It was held that the corporation was entitled to the $13,777 profits.

4. The promoters of a plantation company purchased land in Cuba for $40,000 and secured an option on additional land so drawn that it appeared they paid $20,000 for the option, making the total purchase price appear to be $60,000. In fact, nothing had been paid. They organized a corporation and represented to their associates that the plantation cost $60,000. They assigned their option to the corporation, taking $2,000 in stock as their share. Their associates retained the balance of the stock. It was held that the promoters were under a fidu-

ciary relation to the corporation and that the corporation was entitled as against them to the cancellation of the stock so issued to them.

It should be understood that there would be neither legal nor moral objection to a promoter's sale of property to his corporation at a higher price than he paid for it. The only obligation resting on him is that he should not conceal his profits. In practice it is very difficult to prevent concealment and the promoter may readily find methods of making sworn statements as to his profits that will be true, so far as they go, but will not be the whole truth. A scheme much used in buying property that is later to be sold to the promoter's corporation is to have it passed from the original owners first to another corporation owned by the promoter or to a friend of the promoter; then this corporation or friend will sell to the promoter at a price far in advance of what was paid to the original owner and the promoter will be able to assert that he turns it over to the corporation he organizes at cost to himself or at a very small profit. Sometimes the property may be made to pass through two or three intermediate hands in order to make detection more difficult.

103. *Misleading statements constitute fraud.*—Another feature of the promoter's work which should be considered relates to his statements with regard to the enterprise whether made verablly, in correspondence or in prospectuses. These statements are subject to the general principles of the law relating to fraud. The promoter is bound not merely to make his statements accurate, but not to omit any facts of vital importance.

Of course, the same difficulties that are found in all applications of the law relating to fraud are evident here. The promoter may state what he considers to

be the facts and may omit features that he considers non-essential and it would be impossible to prove that his motives and intent were not of the best. We shall see in dealing with prospectuses how easy it is to give a misleading impression without actually making any misstatements.

104. *Contracts on behalf of the corporation and their acceptance.*—Difficulties sometimes arise in connection with the contracts which a promoter makes on behalf of his proposed corporation. As the promoter is not an agent, he has no right, strictly speaking, to act in behalf of the corporation. Courts of equity, however, have modified this strict rule to such an extent that the corporation accepts the contracts by accepting its benefits. Acceptance need not be expressed in words; it may be reasonably inferred from the acts of the corporations.

105. *The promoter's pay.*—The most vital questions that arise between the promoter and his corporation are: How shall the promoter be paid for his services? How large shall his profits be? The promoter usually feels that he is entitled to all he can get. The corporation's stockholders, on the other hand, are apt to be dissatisfied even with a compensation that the promoter considers exceptionally small. The following extract rom the Report of the Industrial Commission[1] states the essential facts.

There are various ways for the promoter to receive his pay. In certain instances, as, for example, the United States Rubber Company, the promoter received for his work 5 per cent of the total stock issued, but had to pay out of this the charges of lawyers, accountants, appraisers, and bankers.

A more usual form of remuneration is to give the promo-

[1] Second volume on "Trusts and Industrial Combination," page VIII.

ter a certain amount of stock with which to buy the plants required and to pay expenses, permitting him to retain the surplus for his profits. In the case of the Rubber Goods Manufacturing Company the syndicate subscribers furnishing cash received for each $100 paid in $100 in preferred stock and $90 in common stock. The promoters had to purchase the plants and were given the entire issue of preferred and common stock. If they could buy the plants for the proceeds of 100 per cent of preferred stock and 90 per cent of common they made the 10 per cent of common stock for their profit; if they had to pay more than that sum their profits were correspondingly lessened; if they could buy for less, naturally they made more than the 10 per cent of the common stock. They were under the express limitation that no preferred stock was to be issued in excess of tangible assets, and no common stock in excess of an amount determined by the earning capacity of the plants, as shown by previous experience, capitalized on a 7 per cent basis.

In the case of the American Smelting and Refining Company, syndicate subscribers for each $100 paid in cash received $100 in preferred stock and $70 in common stock. The promoters received the remaining $30 in common stock, out of which they had to pay the entire expenses of organization. They retained the remainder for their profits. Speaking generally Mr. Chapman states that when a financiering syndicate receives for its subscriptions par in preferred stock and something less than par in common stock the usual custom is for the promoters to receive the remainder of the common stock as pay for their services and for covering the costs of organization. In most cases their profits will depend upon the rigidity with which they can hold down their expense accounts, and, in many cases, where the purchase of plants is entirely in their hands, upon the skill which they can show in making purchases. Usually, of course, a careful appraisement has been made of plants beforehand, so that the basis of the stock issue is well known to all parties interested in the deal. A certain speculative chance is also often given to the promoters through the fact that it is within their

discretion to buy for cash or stocks as they can best make agreements with the vendors. In that case they can sometimes make much better bargains for themselves by paying cash, or, on the other hand, by persuading the vendors to take securities, thus lessening the amount of cash that needs to be paid out. It is regularly the case that the promoter receives his pay in common stock.

Within the last two or three years there seems to have been a more conservative tendency shown by the bankers and others interested in financing the industrial combinations. The man who advances money to buy the various plants is, in many instances, taking a considerable risk and expects often to secure high pay therefor. The extent of his pay is dependent nevertheless largely upon his judgment as to the future course of development of the business of the combination in question. He practically buys securities of manufacturing establishments. If they earn high dividends his earnings will be great, provided he retains the securities; if he sells them his profits will be determined by the market rate of the securities, that being dependent again in the long run upon the earning capacity of the establishments. The more usual terms probably, under which within the last two or three years the financial agreements have been made, are that for each $100 cash paid in the subscribing member of the financial syndicate receives par in preferred stock with a bonus in common stock equal to the preferred less the amount reserved for the pay of the promoter. This reserve has sometimes been as high as 50 per cent of the common stock, sometimes 30 per cent, and sometimes only 10 per cent.

Instead of the plans mentioned above numerous others are of course found, especially where it is more desirable to issue bonds or where for some reason it seems desirable to make special terms, owing to the peculiar situation of some of the members entering into the combination. Promoters sometimes receive specified sums of money for their services; bankers practically always have to take for their services a percentage of the stock or the surplus left over.

106. *The promoter's risks and labors.*—Enough has been said to indicate that the promoter's labors and risks are heavy. If he does his work thoroughly he will probably spend a long time in careful investigation of the enterprise and in examination of all the possible causes of failure before he binds himself in any manner. If he is a man of sound judgment, as he must be in order to be successful, he will probably find serious if not fatal flaws in most of the enterprises that come to his attention. A professional promoter must expect, therefore, to spend a large amount of time and money in studies and investigations that bring him no return. Unless this part of his work is thoroughly done his efforts are foredoomed to failure.

In the process of assembling his proposition, the promoter must always take considerable personal risks. He buys options, enters into contracts, and perhaps spends money for further experiment, all of which will be absolutely lost unless his promotion proves successful.

In financing the enterprise, the promoter puts in jeopardy not only the time and money previously expended, but his business reputation as well. One notoriously unsuccessful promotion will probably end a promoter's activities, at least if he is engaged in an entirely legitimate line of business.

107. *Is the promoter overpaid?*—It is obvious also that the promoter must possess a rare and highly valuable combination of talents. He must be keen, shrewd, a good bargainer, farsighted, prudent, enthusiastic, persuasive, and, above all, he must inspire confidence. With this necessary combination of talents, labors and risks, it is not surprising that the promoter should subsequently claim exact large profits. It is no doubt

true that a considerable number of men who have won success in this field have made millions and tens of millions of dollars in a very short time. To the on-looker it sometimes appears that these millions almost came dishonestly, that it is hardly possible that they are legitimate earnings. The average on-looker, however, has no conception of the amount or importance of the preliminary work which the promoter performs. Neither has he any conception of the large number of failures in this field. Probably the losses of promoters, who have spent their own time and both their own and their friend's money without benefit to themselves, would almost equal or perhaps exceed the total profits of successful promotions.

We must not forget to consider also the great importance to business and industry of their achievements. They are the men who have found and developed the inventions, the improvements and the better organization of industry which underlie our modern prosperity. Frequently the inventor complains that he has made less out of his invention that did the business promoter; the manufacturer complains that with all his years of effort he has made less out of his factory than did the promoter who takes it into a big corporation; the mine owner complains that he has made less out of his land and ore than did the promoter who obtained the funds for its developments. All of these complaints are natural enough; yet they all alike fail to take into account the obvious fact that the promoter's efforts have not done them harm, but good. He has performed for each of them a great service; and even if he retains the larger part of the profits, they have no just ground for complaint.

CHAPTER XIV

CORPORATE PROMOTION—FORMING CONSOLIDATIONS

108. *The importance of small industrial combinations.* —Of late years the most conspicuous and perhaps the most important field for promoters has been the consolidation of manufacturing and railroad companies. The tendency toward consolidation has been even more widespread in the last few years than has appeared to the casual observer. Popular attention has been directed almost exclusively to what is called the trust movement, that is, the combinations of big companies with a view to controlling prices.

Of still greater importance, however, to the average business man has been the tendency to consolidate small local plants, not for the sake of achieving even a partial monopoly, but for the sake of the economies that result from manufacture on a larger scale than is possible by a small partnership or corporation. Among the most important economies that may be thus effected are: first, the elimination of wasteful competition in selling and advertising; second, the opportunity to use expensive and highly specialized machinery more constantly and thereby prevent the loss that results from allowing such machinery to lie idle; third, a position of greater advantage to business managers in their dealings with labor unions; fourth, bringing to bear the best brains and experience to be found in any of the plants consolidated on the problems of each plant.

No statistics have been or could be collected to show

exactly the extent of this movement. It is certain, however, that the great mass of the manufacturing capital of the United States is now employed by such consolidations and that the position of the small isolated manufacturer is daily becoming more precarious. Indeed, the result is inevitable, for the consolidation can usually effect the economics mentioned above without equally great disadvantages. The consolidation, therefore, although it may have no monopoly and no control over prices, either of raw materials or of finished products, easily undersells its small competitors. It is not worth while to rail against such a movement; business men will do better to recognize its inherent strength and get into line.

109. *Difficulties in the promoter's task.*—The formation of a consolidation through the medium of a holding company, which is the usual form, is by no means an easy task. It brings into play all the shrewdness, persuasiveness and business judgment that a promoter may possess. Usually managers and owners of the various plants to be taken into the proposed consolidation are so mutually jealous and antagonistic that it is next to impossible for any one of them to effect a friendly combination with all his competitors. Once in a while a successful manufacturer may buy outright the securities, or perhaps the physical assets, of competing plants; but this is an exception. Usually the promoter of a consolidation must come from the outside. He will probably be better off if he has had no connection with the business and therefore has no grudges and no prejudices to overcome. Sometimes the outside promoter is a banker friendly with all the interests to be combined; sometimes he is a well-known promoter who has made a name for fair dealing and success; sometimes he is a

security holder in one or more of the concerns to be consolidated, who has taken no active part in their management. He will of necessity have constantly at his command the expert knowledge of men directly concerned with the business.

For the sake of simplicity we will first consider the process of consolidating two or more small independent partnerships or corporations into a somewhat larger combination of some local importance; and after that we will consider the still more complicated problems that arise in the process of forming a big "trust"—using that word in the popular sense—a combination of previous consolidations.

110. *"Discovery" of a small consolidation.*—In organizing a small consolidation the promoter's first step, as has already been indicated, must be a thorough investigation of all the concerns which are to be included. Usually the promoter will not have the time or the facilities to undertake such an investigation personally or by means of his own assistants. But he should certainly be unwilling to accept the unsupported statements of the manufacturers; he will, therefore, use the services of competent engineers, of expert public accountants and perhaps of lawyers. The accountants' examination should produce the most important and significant results, and on these results the terms of the consolidation will probably be based.

The accountant's work in this connection should be even more extensive and searching than in the case of a regular audit. This is particularly true because the managers in the case of an audit presumably desire a correct report; in the case of this special investigation their interests lead them to favor over-valuation of assets, fictitious accounts receivable and a padded in-

come statement. The accountant must get an accurate physical inventory of the property, if possible; he must verify the accounts and bills receivable as well as the accounts and bills payable; he should look into all indirect and contingent liabilities with great care; he must see that sales do not include goods sent out "on consignment" and "on approval" and that profits are not swelled by sales of what are in reality capital, not current, assets.

111. *Basis of consolidation.*—The promoter's next step, if he is acting not simply on his own account, but as a sort of arbitrator for the various manufacturers, each one of whom is willing to go into the consolidation on reasonable terms, is to draw up a tentative "basis of consolidation." In an article in *The Journal of Accountancy* for November, 1908, Mr. F. H. McPherson, F. C. A., gives in illustration the following informal memorandum of agreement which was used as a basis in a certain consolidation of small companies with which he was concerned. The agreement is typical and is well worth careful reading. It is given in full below:

Basis of Consolidation:

A corporation to be formed under the laws of the State of Michigan, with a paid-up capital of ten million dollars, to be apportioned into 6 per cent preferred stock and common stock, as the parties interested may hereafter determine.

This corporation to purchase all the assets, property, goodwill, etc., of all the four companies and to pay therefor in preferred and common stock and by an assumption of the indebtedness of each company.

The amount of preferred and common stock, to be paid to each company, to be determined by the value of the net tangible assets and the valuation placed upon the earning power of each company.

In placing a value upon the tangible assets, same to be reached as follows:

(1) The land, buildings, machinery, tools, and patterns, to be determined by appraisers, to be chosen by a majority of a committee made up of one appointed by each of the companies; on failure of this committee to agree on appraisers the selection to be left to the committee who present these suggestions.

(2) Inventories of raw materials, work in progress and manufactured stock to be taken, and valuations placed thereon by the individual companies, and this to be done under the supervision of a disinterested party, to be named by the committee.

The inventories are to be made as of the same date, and to be taken at substantially the same time.

When completed the inventories are to be passed and agreed upon by a committee consisting of a representative of each of the companies and one to be named by the committee. The decision of these five to be binding.

(3) In reaching the value of the earning power of the several companies, consideration is to be given to the following details:

(a) That profits are incidental to the business and have not been anticipated.

(b) To the charging to operating expenses of items, exceptional or unusual, and which have had the effect of reducing profits below normal.

(c) The effect upon the earnings of the money paid out as interest upon borrowed capital, in case it be found that the borrowings (loans) made by the several companies are disproportionate to each other.

(d) That all charges to operating expenses are proper charges against the business and that they are made for and during the proper period.

(e) That proper and reasonable allowances have been made for repairs and renewals and that these have been charged against earnings.

(f) That charges against earnings for depreciation are adjusted upon an equitable basis.

(g) Such other matters as appear from an examination of the accounts and which would prejudicially affect the earnings of any of the companies, either advantageously or disadvantageously.

(h) The value of the earning power to be determined by a consideration of the business done by each of the several companies for the three years, 1903, 1904 and 1905.

(i) Accountants to be selected by the committee and questions which may arise as to treatment of various matters and about which there is difference of opinion, to be determined by the committee.

(j) All costs and expenses incurred in making appraisals, examination of accounts, or of performing the other duties in connection with the formation of the proposed new company to be charged to and borne by the new company; should the new company not be formed, then such costs, expenses, and disbursements to be borne by the four individual companies in proportion to the number of men employed by each.

It will be noted that the agreement just cited does not specify just when preferred and when common stock shall be paid by the holding company for the securities of the subsidiary companies. One very common arrangement is set forth in the following extracts from another actual agreement where several fair-sized manufacturing corporations and partnerships were to be consolidated. This agreement provided:

Each vendor executing this agreement also executes and delivers a schedule of the entire property, which it sells to said purchaser, setting forth briefly the various classes of property, with the sufficient description of the several items of real estate, plant and movables to identify the same, which schedule sets forth the value of the entire property so sold, the tangible and

intangible property in separate items, the tangible property being valued as prescribed by subdivisions a and b in the Method of Appraisal hereinafter set forth, and the value of its intangible property ascertained and certified by one or more responsible public accountants, as prescribed by subdivision c of said Method of Appraisal, together with a statement of any additional facts, and of the valuations based thereon, which, in the vendor's judgment, may aid the Appraisal Committee in exercising the discretion conferred upon it by subdivision b of said Method of Appraisal. The valuations of the tangible and intangible properties so made by each vendor shall be considered as *prima facie* evidence of the true value of said vendor's property for the purposes of sale, but shall in no case be controlling upon the Appraisal or Executive Committee hereinafter appointed, such valuations or prices being subject in all cases to any investigation and modification which the said committee or committees may deem that justice requires; the total of such valuations as verified or modified according to the terms of this agreement, to be the purchase price which said vendor is to receive for its entire property so sold.

PURCHASE PRICE

The purchase price to be paid to such vendor for the property sold by it to the purchaser shall be the total value of its tangible and intangible property and shall be paid in stock of the purchaser at par, as follows:—

1. *Tangible property paid for in preferred, etc.*

Each vendor whose net earnings for the six months ending July 1st, 1898, amount to 4 per cent—that is, at the rate of 8 per cent per annum—on the value of its land and plant, ascertained as above, shall receive preferred stock for the full value of all its tangible property.

Any vendor whose net earnings for the said period of six months shall amount to less than at the rate of 8 per cent per annum on the value of its land and plant, shall receive preferred stock to the amount of twenty-five times its net earn-

ings for said six months; and the balance of the value of said tangible property it shall receive in common stock.

Each vendor has upon its schedule set forth a statement of its net earnings for said period, which is subject to modification by said committee under the above rules applicable thereto.

2. *Intangible property paid for in common stock.*

The entire value of the intangible property, ascertained as per this agreement, shall be paid by the purchaser in its common stock at par.

Simultaneous with the sale and transfer of its properties each vendor shall receive from the purchaser in stock, or if permanent certificates are not ready, then scrip for the same, one-half of the purchase price to which it claims to be entitled by its schedule, less an amount of preferred stock equal to 125 per cent of its mortgage indebtedness, if any, and the remainder of said stock shall be withheld by the purchaser until the exact amount of the purchase price shall have been finally determined as herein provided, whereupon the vendor shall become entitled to the remainder of the purchase price, but the purchaser may out of such remaining stock retain an amount thereof sufficient to secure it against any defective title and against any indebtedness which is not otherwise sufficiently provided for.

APPRAISAL, ETC.

Each vendor expressly covenants and agrees that the property set forth by it in its schedule has been fairly and honestly valued in accordance with the following rules and methods, which shall be the rules and methods to govern the Appraisal and Executive Committee in their verification or modification of the same.

METHOD OF APPRAISAL.

(1) *Tangible Property.*

(a) Land:

Land shall be separately appraised at its actual value without reference to plants thereon, and consideration shall be

given to special adaptability or want of adaptability to the business.

Plants shall be appraised apart from the bare land at their value to-day to a going concern for the purpose for which used, based upon present cost of construction at the same places respectively. No vendor shall set forth in its schedule any unimproved land or other property belonging to it which is neither a part of the plant of such vendor nor essential in the operation of the same, nor shall the same be purchased by the second party.

(b) Materials, Supplies and Manufactured Product.

These shall be appraised at what it would cost to replace the same at the place and date of the transfer of the same to the purchaser.

(2) *Intangible Property.*

(c) Intangible property shall be appraised by multiplying by ten the average yearly earnings during the past five and one-half years, which shall be ascertained as follows:—

In order to arrive at the earnings of the property sold by each vendor and to determine on a uniform basis fair for all, the earning power of the property so sold, each vendor shall add to its net profits such of the following items as have been theretofore deducted by said vendor in ascertaining its net profits during said period.

1. Interest on indebtedness.
2. Insurance of any description.
3. Arbitrary items of depreciation or wear and tear not paid out or actually incurred as a debt and all items of new construction.
4. Also salaries and compensation paid to officers, directors, partners, trustees, superintendents of departments or works, general managers, auditors, cashiers and chief accountants, but all wages, salaries and compensation paid to laborers, servants, foremen, clerks and employees in subordinate positions shall remain charged against earnings.
5. The accountants must ascertain the amounts expended by each of said vendors for repairs, renewals and maintenance of plant which have been deducted from earnings during said

period of five and one-half years, and the said amounts so ascertained are set forth on the schedules of said vendors.

In order to place said vendors on a uniform basis as to the amounts expended, or which ought to have been expended, for repairs, renewals and maintenance of plant and charged against or deducted from the earnings during said five and one-half years or other period, each vendor shall add to said earnings any amount actually expended by it for repairs, renewals and maintenance of plant which it has heretofore charged against and deducted from said earnings, and there shall then be charged against and deducted from said earnings of each vendor ascertained as aforesaid, annually a sum equal to 3 per cent of the schedule value of the plant of said vendor completed prior to the last date of the five and one-half years or other period applicable to said vendor.

In the case of those vendors, if any, which shall not have kept a separate repair account the amounts expended by them for repairs, as required by this subdivision, shall be ascertained as nearly as possible by the accountants and the committee of appraisal from the books of such vendors and from the condition of their plants and otherwise, and in default of information to the contrary it shall be assumed that they have expended in repairs a sum equal to 3 per cent of the value of their respective plants.

Having by the foregoing methods, ascertained the earnings, there shall thereupon be deducted from the average annual earnings of each vendor for said period, a sum equal to 5 per cent (5%) of the value of the land and plant sold and completed prior to the last date of the five and one-half years or other period applicable to such vendor, and the balance of said average annual earnings so ascertained shall be deemed for the purposes of this agreement the net profits of the respective vendors to be severally multiplied by ten as aforesaid.

Provided, however, that in case it shall be found that the aforesaid multiplier of ten will produce a grand aggregate of common stock greater in amount than the grand aggregate of preferred stock, the Executive Committee shall choose such

lower multiplier as will limit the grand aggregate of preferred stock.

Provided, further, that in the event that the grand aggregate of the average annual net earnings of the vendors, ascertained as aforesaid, shall be found to exceed 12 per cent of the total value of the tangible property, then said Executive Committee in its discretion may choose such multiplier as will fix the volume of common stock as closely as may be at an amount upon which such past net nearnings would show 6 per cent applicable to dividends upon such common stock after providing for the dividend on the preferred stock.

And thereupon such newly chosen multiplier (whatever the same may be) shall be the multiplier to be used in the case of each vendor.

The agreement that has just been cited in part deserves careful study. As the extracts given are self-explanatory, however, it will be left to the reader to work out for himself the exact methods employed by the promoters, and accepted by the owners of the plants in determining values. The substance of the plan, it will be seen, is that tangible property is to be represented by preferred stock in the consolidation and additional earning power by common stock. This puts the consolidation, so far as capitalization is concerned, on a conservative basis. The same plan, slightly modified, is widely used.

112. *The necessity for cash.*—Having investigated and assembled his proposed consolidation, the promoter must next arrange for its financing. It may be said at this point that the basis of consolidation in itself finances the new consolidation, inasmuch as it provides for the exchange of the consolidated company's securities for the subsidary companies' securities. This financing is not sufficient, however, to provide for the needs of the new corporation. Working capital, to a considerable

amount, must certainly be obtained or the new corporation will plunge at once into bankruptcy. Furthermore, a consolidation almost always implies changes in methods of operation. New officers must be appointed, old ones dismissed. Some of the plants perhaps will be dismantled or put on part time; other plants will be remodeled and refitted with expensive modern machinery. Frequently the whole arrangement of the plants and processes of manufacture will be reformed in order to introduce the methods that belong to large scale production. All of these changes may be necessary in order to obtain the economies that belong to combinations. They may and probably will prove wise and in the end highly profitable. At the moment of forming the consolidation, however, they call for large amounts of new capital funds and bring to the front some of the most difficult problems of financing which a promoter has to face.

113. *One method of raising cash.*—Following the basic principles outlined in Chapter XII, the promoter of a small consolidation will endeavor to raise whatever cash is necessary first of all from local bankers and financiers. If he succeeds in obtaining the cooperation of these men, he is much more likely to find his proposition regarded favorably by larger banking interests. Two courses are now open to him; either he may issue bonds of the new company, which will not be first mortgage, but which he may name "first and refunding" or "first general" or "first consolidated"; or he may try to sell stock in addition to that which has been given to the owners of the consolidated plants. Either course has its disadvantages. The bond issue probably cannot be sold on advantageous terms because the consolidation must necessarily be an experiment at

the beginning and even its best securities will have a speculative character. Furthermore, in many cases the promoter will find the property of the subsidiary companies already mortgaged so that the bonds of the consolidated company, whatever title he may pick out for them, will be in reality junior liens. The sale of stock is undesirable because the stock issue in all probability is already large; it has to be large in order to make the terms offered to the owners of the subsidiary plants sufficiently attractive. If still more stock is issued to be sold to the public, it will be very difficult to pay dividends even on the preferred, not to speak of the common. This result, the promoter certainly does not desire. He has promised usually heavy cumulative dividends at once on the preferred stock and has held out hopes of early dividends on the common, and his reputation is staked on the fulfillment of these predictions. Moreover, he is himself usually a large holder of the common stock.

On balancing these considerations, the promoter usually finds himself strongly inclined to favor the sale of bonds if they can be sold at any reasonable price. His sanguine temperament—for that kind of temperament naturally belongs to a promoter—leads him to minimize the danger of increasing the new corporation's fixed charges and to exaggerate the probable profits. He therefore turns to local bankers for assistance in borrowing the necessary funds. Frequently, as the first step, he has the corporation put out a bond issue under a mortgage of the limited open-end type. The provision may be, and often is, that of the total issue one-half shall be offered for sale in the first year, one-fourth in the second, and one-fourth in third year; of course, the length of time over which the sale is spread and the

corporation's allotment each year may vary indefinitely, depending on the urgency of the company's need for cash. He then obtains a guarantee from local financiers, including perhaps some of the banks, to take the unsold bonds at the end of each period from the corporation at a low price which is specified. By this guarantee the corporation is protected from an absolute failure to secure cash. The guarantors must, of course, be paid, usually by a considerable commission on all the bonds that are sold. This kind of arrangement, which we will consider at greater length later, is known as underwriting.

The promoter may now take his bond-issue—or part of it, if he has been able to get the sale of only a part guaranteed—to a friendly bank and secure a short-time loan, using the bonds as collateral security. He has thus provided for the immediate cash necessities of the new company at the beginning of its existence. As fast as he can sell the bonds, he pays off the bank loans and thus puts the corporation in a stronger financial position. If the issue is entirely successful, the corporation will soon have plenty of cash, obtained by this bond issue, and will be able to carry out the improvements in operation which are expected to make the consolidation a profitable venture.

The essential feature of this plan, it will be noted, is the distribution of the risk among several different parties. The bank is well protected in accepting the bonds as collateral by the guarantee of responsible parties to buy the bonds at the end of a certain period, if no purchaser willing to pay a higher price is previously found. The guarantors usually take little risk, for the price of the bonds to them is made low enough to be attractive. The corporation obtains at once what-

ever cash is necessary and its only risk is that it may have to sell its bonds to the guarantors at a low price.

Naturally the promoter in the period left to him before the guarantors' option becomes effective does his best to sell the bonds at a good price. The methods which he uses and the agencies through which he works are fully treated in later chapters.

114. *Problems in forming a large consolidation.*—There is no difference in principle between the promoter's functions in forming a small and his functions in forming a large consolidation. He is doing things on a bigger scale, however, and finds necessary several important variations in his methods.

In the first place, such a consolidation is almost always too large to be handled by any one man. In order to reach all the parties concerned and to inspire confidence, it is generally desirable for several promoters to work together, each performing a portion of the labor. When the United States Steel Corporation was formed, as described in the following chapter, almost all of the prominent, successful promoters of the country were concerned in one way or another. Apart from the necessity of dividing the work to be performed, it is very desirable to promote harmony and secure the best solutions of the difficult and complicated problems involved in such a consolidation by getting the ideas of a considerable number of able and experienced men.

In the second place, the promoter or group of promoters is dealing with such a large number of security owners of subsidiary companies that lengthy consultation with these owners and bargain-making is out of the question. Usually the heavy stockholders in the subsidiary companies are consulted and frequently they have some part in the scheme of promotion. The great

mass of stockholders, however, are simply notified, when the proper time comes, of what is proposed and are invited to accept the offer which the promoters lay before them.

115. *Basis of consolidation.*—The amount and character of the security issues of the proposed consolidation, and the terms upon which these securities will be exchanged for the securities of the subsidiary companies, are fixed by the promoters in advance. This does not mean that the terms are unfair to the subsidiary companies' stockholders. On the contrary, they are usually extremely liberal. It must be remembered that it is very desirable for the holding company to have all the stock—certainly all the voting stock—of each subsidiary. The less subsidiary company stock there is left outstanding, the less is the chance of complaint and annoying legal processes on the part of the dissenting stockholders against the actions of the holding company. The promoters, therefore, try to offer such terms that all, or almost all, the stock of subsidiary companies will be exchanged for stock of the consolidation.

The usual arrangement is to divide the capital stock of the consolidation into preferred and common, the amount of the preferred being equivalent to the total market value of all the subsidiary company stock. Practically any amount of common stock may be issued; the promoter usually puts out as much as he thinks can possibly obtain dividends within a reasonable number of years. The stockholders of the subsidiary companies are then offered somewhat more than the market value of their stock payable in cash, or considerably more than its market value payable in preferred stock. If they take preferred stock, they will ordinarily receive in addition a substantial bonus of common stock.

The first proposition is intended to catch the ultra-conservative; the second proposition is intended to be even more attractive. The stockholder is to receive in place of his present holding, having a fluctuating and uncertain dividend, a more than equal amount of stock preferred as to dividends, and in addition a considerable amount of the new common stock. Very few stockholders are likely to refuse so attractive an offer.

The application of these principles is well illustrated in the promotion of the biggest and one of the most successful consolidations that has yet been formed, the United States Steel Corporation. So important is this great company, not only in connection with our present study of corporation finance, but in its influence on industry in this country, that it has been thought best to devote a separate chapter to a review of its origin, its promotion, its financial history and its prospects.

116. *The Interborough-Metropolitan Consolidation.* —Another typical consolidation which was formed under very different conditions is the Interborough-Metropolitan Company, the holding company for the transportation companies of New York City. A chart showing the complicated internal organization of the company has been presented in Chapter VI. The terms of the consolidation are clearly set forth in the following extract from a lecture by Albert W. Atwood, Financial Editor of the *New York Press* and Lecturer on Investments in New York University.

1. Companies Taken Over.

Metropolitan Steel Railway	$ 52,000,000	stock
Metropolitan Securities Co.	30,000,000	"
Interborough Rapid Transit Co.	35,000,000	"
	$117,000,000	

2. Capitalization of Inter-Met.

Bonds	$ 70,000,000
Preferred Stock	55,000,000
Common Stock	100,000,000
Total	$225,000,000
Deduct	117,000,000
Excess	$108,000,000

3. Basis of Exchange.

Interborough — one share received $200 bond and $99 common stock in the Inter-Met.

Metropolitan Street — one share received $100 preferred and $55 common in the Inter-Met.

Metropolitan Securities — one share, $75 paid up, received $93.50 common in the Inter-Met.

The Interborough-Metropolitan took over practically all the capital stock of the subsidiary companies. In 1902 the Metropolitan Street Railway, which had been the company which controlled and operated the surface lines, ran short of money and a scheme was devised to keep it going by leasing it to the New York City Railway (which had a comparatively small amount of stock) the stock of which was in turn all taken over by the Metropolitan Street Railway shareholders. By getting a large majority of the stocks of the Metropolitan Street Railway and the Metropolitan Securities Company the Inter-Metropolitan got control of the entire surface system and by securing the stock of the Interborough Rapid Transit it got control of the subway and elevated lines. The total of securities taken over was about $117,000,000 and the new company issued $225,000,000 of securities. The excess capitalization was $108,000,000, which in view of the fact that many believed the surface lines were already waterlogged, was a remarkable piece of finance. Three reasons are advanced for the excess capitalization:

1. The promoters say they honestly believed that within two or three years the common stock would be earning 2 per cent.

2. The merger was formed at the height of the business and financial boom of 1906 and at that time the later financial and business reaction was not generally foreseen.

3. The holders of the securities of the old companies had to have an inducement to exchange their securities for the new ones. In other words, they had to be hypnotized into believing that they were getting something for nothing. Much was made of the growth of the passenger traffic in New York and the official prospectuses declared the common stock of the new combine would certainly be able to pay dividends in time owing to the growth of population.

These two illustrations will serve to indicate the general practice in exchanging a consolidated company's securities for those of the subsidiary companies. It may be observed that the steel consolidation was far more conservative than was the Interborough-Metropolitan consolidation. The second-named company was in a dangerous situation from the very beginning, for it was compelled to pay regular interest on its large bond issue or go into receiver's hands. The steel corporation gave only a small amount of bonds—relative to its total capitalization—and consequently was not in serious danger of insolvency. Even if it had failed to pay interest on its preferred stock it would not have been forced into a perilous position. The Interborough-Metropolitan financing was on its face so unsound as to arouse the suspicion that this particular consolidation was never intended to succeed.

117. *Canada's experience in forming consolidations.* —Canada's experience in industrial consolidations has been confined to recent years, more particularly from 1910 to 1918 inclusive. Indeed, it has been a new factor in corporation financing in that country and one which has not proved eminently successful. Generally speak-

ing, the features of the movement have been the large number of consolidations, the heavy capitalization (often proving to be over-capitalization) and the consequent necessity for reorganization. In the volume on "Investment and Speculation," figures are cited showing that the number of industrial mergers negotiated in the Dominion from January, 1909, to January, 1913, was 56. The aggregate authorized capitalization (including bonds) of these mergers was $456,938,266. The 56 amalgamations absorbed 248 individual companies. The aggregate capitalization of 206 of these individual companies was approximately $167,289,182, which amount in various ways was increased upon amalgamation. The 40 securities issued to the public, resulting from the amalgamation movement, totalled $57,346,666. With 16 of these, amounting to $16,500,000, an aggregate bonus of $6,750,000 was given. The largest consolidation was the Canada Cement Company, which absorbed twelve companies. Its authorized capitalization, including bonds, amounted to $38,000,000.

Amalgamation operations have not been confined to one or a few classes of commodities. Companies handling soap, cereals, asbestos, bread, flour, milk, cars, leather, lumber, cement, dried fish, carriages, bolts and nuts, steel, coal, ice, felts, shoes, furs, crockery, paint and jewelry, have all seen apparent or real gain in a combination of interests. Arrangements have also been made between navigation, light and power, brewery, canning, retail box and numerous other companies. These instances are sufficient to exemplify the widespread nature of what is a new feature in Canadian commerce and finance.

Among the objects and advantages to be gained by consolidation, the following have been cited by promoters in Canada:

The standardization of brands.

Elimination of needless competition.

Securing of further working capital.

Prevention of increase in prices to the public.

Keeping pace with the growing market demand.

Elimination of a large amount of freight charges.

Savings from the concentration of the executive force.

Economies in the purchasing, manufacturing and selling departments.

Ability to establish branches of the one company in various parts of the country.

Specialization of various plants, dispensing with unnecessary duplication of output and patterns.

Although, naturally enough, the fact that companies have found themselves in a critical condition, is not stated by promoters as a reason for consolidation, this was probably the real cause in some cases. Keen competition, bad financing or disaster on the part of one company might be met to some extent by being swallowed by a combine.

118. *Basis of consolidation.*—The basis of consolidation is one of the most important considerations for the shareholders of the companies absorbed. The promoters of amalgamations in Canada have given little information to the public on this point. Generally speaking, the companies forming the merger have taken bonds, preferred or common stock in the combine. Supposedly, the individual companies have usually desired a fairly large holding of the amalgamation's bonds. Preferred stock has sometimes been accepted with, in some cases, a bonus of common stock. In the formation of these new companies, it would seem that comparatively little cash has been paid by the consolidation for the properties of individual companies.

This exchange of securities might possibly lead to undue inflation of capitalization including the bond issue, but there are two counteracting influences: *first,* the companies entering the trust would naturally wish to obtain a fairly large share of the bond issue, which ranks first in the matter of interest payments; *second,* if the bond issue were made unreasonably large it might prove a difficult task to make the earnings of the amalgamation sufficient to pay the interest on the bonds. The average merger bond should prove a safe investment, although in Canada, unfortunately, it has not always done so, owing chiefly to over-capitalization.

One of two instances of the basis of consolidation may be cited. In the case of the Steel Company of Canada, the various concerns included agreed to accept the bonds of the amalgamation for two-thirds of the appraised value of the properties. They also agreed to accept preferred stock for the remaining one-third of the appraised value plus the liquid assets of the properties, and common stock against the earning capacity as demonstrated by the history of the company.

An important provision is that by which the company is prevented from paying dividends on its common stock until such time as, from earnings of the company, there has been placed in the treasury a sufficient amount to pay dividends on the preferred stock for one year in advance.

When the sale of the Brantford Screw Company to the Canada Bolt and Nut Company was confirmed by the shareholders of the former concern, the following division of stock was agreed upon: holders of Brantford Screw Company preferred were to receive seven per cent cumulative preferred stock in the Canada Bolt Company, at the rate of $145 for every share, and in addition,

a bonus of thirty per cent in the common stock of the new company. Holders of the Brantford Screw Company common stock received $120 in new preferred and thirty per cent in new common.

The proceeds realized by the Canadian Pacific Lumber Company, Limited, from the sale in July, 1911, of $1,750,000 (approximately) six per cent first mortgage bonds to bearer, less expenses, were to be applied exclusively in carrying out the consolidation of the five properties in which it became interested. The proprietors relied entirely for their profit on their holdings of shares in the company.

Of the $3,650,000 six per cent first mortgage and collateral trust bonds of the Canadian Steel Foundries, Limited, issued in March, 1911, $2,900,000 (including a public offering in London of $2,000,000) were issued for the purchase or acquirement of control and for the development of the properties of the Montreal Steel Works, Limited, and the Ontario Iron and Steel Company, Limited. The sum of $750,000 was retained by the trustee for retiring a similar amount of bonds of the Montreal Steel Works, Limited, then outstanding.

119. *Dangers of over-capitalization.*—The capitalization, and, in that connection, the issue of securities to the public, is perhaps most liable to abuse by self-interested promoters. In most cases the aggregate capital of the mergers is in excess of the total capitalization of the companies absorbed. Good reasons have sometimes been advanced to account for that fact, but this is a phase of the amalgamation movement, concerning which by no means sufficient information has been given by the average merger promoter. Making allowance for various considerations, the capitalization of the aver-

age consolidation in Canada still appears to be larger than that of the total capital of the contributing corporations.

After allowing for money required for extensions, reorganization, new factories, and the like, one must conclude that a proportion of the securities issued by the mergers has been what is popularly known as "watered stock." Although many companies have not issued securities to the limit of authority granted them, their power to place bonds and stocks upon the market in future may extend far into the next decade. If stock and bond issues of the amalgamations are forced into domestic and other markets, with an appetizer in the shape of a bonus, there is likelihood of protest on the part of the public. This is especially so in the London market, where the securities of several Canadian mergers have been floated and are likely to be sold in the future. The investor will regard favorably the stocks and bonds of a consolidation conservatively planned and financed without an ill-concealed effort to market practically useless and valueless securities. Stock watering is usually accomplished with ease, but the public are becoming more accustomed to analyze the statements of new companies and to invest accordingly.

As has been stated previously, a large number of industrial consolidations in Canada have had to undergo drastic reorganization.

120. *Reorganization of industrial consolidations.*—One of the most notable breakdowns of recent years among the consolidations of Canada was that of the Amalgamated Asbestos Corporation, Limited, in 1912. Action was taken by the directors, and a bondholders' committee was appointed to save the company from complete disaster. A new concern, the Asbestos Corpora-

tion of Canada, was formed, and the old company's properties were purchased. The capital and bonding powers were $7,000,000, divided as follows: First mortgage forty-year, five per cent bonds, $3,000,000; six per cent preferred participating stock, $4,000,000; common stock, $3,000,000—total, $10,000,000. This compared with a stock and bond capitalization of $2,500,000 of the old company.

In submitting their reorganization scheme, the bondholders' committee pointed out that it was evident from the operation of the company that the original capitalization, involving a fixed charge of $400,000, was excessive. The average earnings for a period of three and a half years were not less than $250,000, and under normal conditions the company should exceed this. The plan of reorganization suggested was the formation of a new company, with a capitalization of $5,000,000 bonds, of which $2,875,000 were issued at the outset, $4,000,000 of six per cent participating preferred stock, and $2,875,000 common stock. Under this plan the holder of $1,000 par value old bonds received $250 new first-mortgage bonds, $500 new six per cent preferred stock, and $250 new common stock. To provide working capital, it was proposed to sell $875,000 new first mortgage five per cent bonds. The annual statement for 1911 showed that the profits for the year were only $98,003, against a bond interest of $400,000, unfavorable conditions in the trade, and the unsatisfactory result of certain contracts telling heavily against the company.

The Black Lake Consolidated Asbestos Company was another Canadian concern which encountered financial difficulties, and was reorganized in 1912. A new company, the Black Lake Asbestos and Chrome Company,

Limited, was formed, with bonding powers and capitalization as follows:

Six per cent income bonds (to be issued bond for bond to holders in the old company)	$1,250,000
First mortgage 6 per cent bonds (to be held in treasury)	250,000
Preferred stock	1,000,000
Common stock	3,000,000
	$5,500,000

The capital stock and bonds of the old company were as follows:

	Authorized	Issued
Bonds	$1,500,000	$1.230,000
Preferred stock	1,000,000	1,000,000
Common stock	3,000,000	3,000,000
	$5,500,000	$5,230,000

It is interesting to note that two reorganizations of Canadian industrial consolidations resulted in wiping out stock and bonds, mostly "water," aggregating $19,-000,000.

121. *Most complicated merger in Canada's history.*—One of the most important and far-reaching consolidations during recent years, in Canada, was the merging of its lake steamship companies.

To create this consolidation, a new company was formed called the Canada Transportation Lines, Limited, the authorized capital of which was $25,000,000, divided into 125,000 seven per cent cumulative preference shares of $100 each and 125,000 ordinary shares of $100 each, and with authority to issue thirty-year first

mortgage debenture stock of $8,000,000 bearing interest at five per cent with power to increase the amount of such mortgage debenture stock from time to time, providing the proceeds were used for the purchase of new boats or other property necessary for the company to acquire, and on terms fully set forth in a mortgage trust deed.

The new company will eventually acquire as going concerns, including all their assets, good-will and profits for the current year, the following companies: Richelieu and Ontario Navigation Company; Inland Lines, Limited; Northern Navigation Company, Limited; Niagara Navigation Company, Limited; St. Lawrence River Steamboat Company, Limited; Richelieu and Ontario Navigation Company of U. S. A.; Quebec Steamship Company, Limited; Canada Interlake Line, Limited; Ontario and Quebec Navigation Company, Limited; Merchants Montreal Line; S. S. Haddington, and the Thousand Island Steamboat Company, Limited.

The assets of these companies were appraised and the accounts audited. The appraisal company's reports and auditors' statement were open to the inspection of the shareholders. The new company had assets, as shown by the statement of the appraisal company, of $33,055,-538, in which vessels were valued at $16,866,834; real estate, buildings and dock properties at $5,450,267.99; $661,531.04 cash on hand, and the sum of $8,694,969.89 represented the value of leases, contracts and good-will acquired by the company and covered by ordinary shares. The company started free from debt over and above the debenture stock issued and current amounts. The net earnings of the consolidated companies for the year ended December 31, 1912, were $1,494,554.48, which showed a margin for the payment of interest on

debenture stock and interest on the preferred stock with a fair amount applicable to reserve and ordinary stock.

Allowing for the new tonnage not in operation in 1912, on the same basis as earnings on similar tonnage in 1912, the increase in net earnings over the previous year from that source alone was estimated at $263,000.

Little information was obtainable as to the terms of exchange for shareholders of the companies entering the consolidation. According to Mr. James Carruthers, president of the Richelieu and Ontario Navigation Company, one of the largest entering the merger, the important point that the directors had to consider was whether, in their opinion, it was in the interests of the Richelieu shareholders to sell out the assets and undertakings of that company, and if so, whether the Richelieu shareholders were, in their opinion, obtaining a fair share of the stock of the new company for the stock which they held.

Severe criticism was leveled at the promoters of this navigation consolidation as to what was termed "the disappearance" of eight and a half millions of common stock. This eight and a half millions was left over after the purchase of the Richelieu and Ontario Navigation Company's stock. Following this purchase, the Canadian Transportation Company had to secure control of the Interlake Line, the Quebec Steamship Company, the Thousand Island Line and other interests which absorbed in the neighborhood of four and a half millions of the eight and a half millions stock left over. This left in the neighborhood of four milllion dollars to be divided between the Canadian promoters of the merger and the English houses who financed the project. It is said that the English house which put up the money exacted stiff terms and secured the major part of the

four millions of common stock. This left but a little over a million dollars to be divided between the Canadian promoters and interests who brought about the consolidation which, as a Montreal critic said, "In view of the magnitude of the merger, the amount of time they devoted to it and, in contrast to some of the gratuities other promoters have secured, is not out of proportion."

In financing the merger, it was planned to issue $7,500,000 five per cent debentures which would retire all outstanding bond issues and permit of but one security being placed on the market. In some cases it was proposed that the transfer of bonds should be on a basis of earning power whether they were "seasoned" or not. Those who objected to an exchange of bonds would in all probability be offered a cash price for the holdings.

It was believed by the promoters to be in the interests of the water transportation companies of Canada that they should get English capital on a large scale interested in this business just as it is to-day interested in the great railroads of the country. The only way this could be accomplished successfully, in their opinion, was to be connected with a new company large enough to command the interest of some of the most important financial houses in London. The $25,000,000 authorized capital of the new company will be listed on the London Stock Exchange and a substantial portion of the preferred stock was to be taken at par by strong financial interests in London.

CHAPTER XV

THE UNITED STATES STEEL CORPORATION

122. *Preparing the ground.*—1890 to 1900 is an important decade in the history of the steel business of the United States. Between 1890 and 1893 production was vastly increased, while the demand for iron and steel products practically stood still. As a result, prices were declining and a majority of the steel producers were in a precarious situation even before the severe crisis of 1893 began its work of destruction. The crisis hit the steel makers especially hard, and wiped out many of the small concerns. In the five years of depression that followed, individuals and partnerships as factors in steel production almost disappeared; their places were taken by comparatively large and strong corporations. These corporations not only managed to live, but even to thrive in a way, because they were able to buy new plants and enlarge old ones at bargain prices. By the year 1898 in all branches of the steel industry, including bar iron, rolled iron, steel rails, sheet steel, tin plate, wire and other more highly finished products, a considerable number of fairly efficient and well-managed corporations, which had grown in strength during the depression, were prepared to handle the flood of new business that was expected to come with the revival of good times.

The flood came and with it such a rise in prices and a deluge of profits as would have seemed inconceivable two or three years before. Steel, in Andrew Carnegie's picturesque phrase, is either "a prince or a pauper."

The reason is that, as large amounts of fixed capital must be invested, the supply of steel products cannot easily be increased or decreased; whereas, as steel is not a prime necessity, the demand fluctuates violently. In other words, since supply and demand do not move up and down together, prices and profits jump from one extreme to the other with extraordinary rapidity.

123. *The steel consolidations preceding the formation of the United States Steel Corporation.*—In 1908, then, American steel makers had reached a higher level of prosperity than ever before and were moving rapidly upward; the business was carried on by a comparatively few fairly strong corporations in each line; at the same time, public interest in the advantages of industrial combinations and in their supposed opportunities for great profits was keen and the public appetite for the securities of such combinations, or "trusts," had been excited. Placing these three factors together, we see why the three years following, 1898-1901, were marked by a remarkable series of steel consolidations. We cannot take time here to tell the stories, interesting though they would be, of these consolidations. For our purpose it will be enough to name the important steel companies in existence in 1900.

1. The Federal Steel Company was formed in September, 1908, by combining the Illinois Steel Company, the Minnesota Iron Company, and the Elgin, Joliet and Eastern Railroad. Its authorized capital was $200,000,000 of which, however, only $99,700,000 was ever issued.

2. The American Steel & Wire Company was organized by John W. Gates in March, 1898. It was big enough to control virtually the entire production of wire goods. Its capital was $90,000,000.

3. The National Tube Company, formed in February, 1899, included over a dozen companies. It was the largest concern of its kind in the world and at the time the third largest concern in the iron and steel business, being surpassed only by Carnegie and Krupps, of Germany.

4. The National Steel Company, the American Steel Hoop Company, the American Sheet Steel Company and the American Tin Plate Company were organized in the period from December, 1898, to March, 1900, by Judge W. H. Moore, his brother, James H. Moore, Daniel G. Reid, William B. Leeds, and others who were later given the titles "Moore Party" and "Rock Island Crowd." Of these concerns the largest was the Tin Plate Company, which was a consolidation of forty companies, embracing about 95 per cent of the total output of tin plate in the United States.

5 The biggest and most powerful company of all, The Carnegie Company, was not a consolidation, but a growth. This great concern had been built up by the consistent policy, extending over many years, of putting most of its earnings into improvements, instead of into dividends. The organizing genius of Carnegie, Frick, Phipps, and their co-workers, had made its body of workingmen the most efficient and its enormous plant the most economical in the world. Through its control of the H. C. Frick Coke Company, the Oliver Mining Company, the Pittsburg Steamship Company and the Pittsburg, Bessemer & Lake Erie Railroad, together with its fifty-year contract with the Rockefeller iron, mining and transportation companies, its supply of raw materials at low cost was assured for many years to come.

124. *A condition of unstable equilibrium.*—In one of

the most brilliant chapters in his well-known volume on "Trust Finance" Professor E. S. Meade has well described the conditions in the steel business in 1900. Industrially the situation might be said to be one of unstable equilibrium. It might have been expected that all of these consolidations would have been content to enjoy the prosperity, which was being showered upon steel makers, and would have desisted from intense competition with each other. Ordinarily competitive strife awakens in periods when business is stagnant and mills idle, while harmony is readily secured so long as orders are outrunning production. This would, in fact, have been the happy situation in the steel trade if it had not been for the appearance of a powerful new factor, the tendency toward integration. "Integration" is the economist's technical word for the control by one concern of the whole process of production from the raw material to the finished product. Ordinarily the manufacture of any finished article, say a tin can, is carried on through several stages, and at each stage passes from one group of producers to another group. In making the tin can iron ore must be mined; the miner sells his ore to a manufacturer who transforms it first into iron and next into steel; this manufacturer sells his product to a manufacturer of sheet steel, who in turn passes it on to the manufacturer of tin plate; finally the can manufacturer buys the tin plate and forms it into tin cans. At each stage of such a process there is a sale of the partly finished product and a profit is taken that enters into the final cost of production. Under the policy of integration, according to which all these stages are combined under the control of one great manufacturing concern, a twofold advantage is gained; first, the intermediate profits are all secured; second, a permanent, dependable supply

of raw materials at lowest costs is assured. This second advantage is even more important than the one first named.

The Carnegie Company in 1900 up to a certain point was an integrated company; that is, it controlled great quantities of ore and coal, owned its own steamships and railroads for the transportation of these raw materials to its Pittsburg plants, and at the Pittsburg plants turned out steel rails and a large variety of half-finished products. It was partly for this reason that the company had become so strong and prosperous. Nevertheless, it was by no means wholly independent, for its chief customers were the other steel companies in the Pittsburg district which purchased its steel billets, ingots, bars, plates and slabs. The Federal Steel Company, also, was "integrated" up to a certain point, but like the Carnegie Steel Company was by no means independent of its large customers. A large part of its business consisted in furnishing wire rods to the American Steel and Wire Company and steel billets to the National Tube and the American Bridge Companies. The National Steel Company, a much smaller concern, furnished part-finished products to the other Moore companies, the American Tin Plate, American Sheet Steel, and American Steel Hoop.

The group of producers of finished steel products were by no means satisfied with their position. They desired to secure the advantage of integration for themselves; particularly they were anxious to free themselves from the domination of the concerns on which they were dependent for raw materials. Therefore, all of these companies in 1898, 1899 and 1900 were planning to purchase ore and coal lands, to get control of transportation companies and to construct furnaces and mills for the

manufacture of part-finished steel products. The American Steel and Wire Company brought two thousand acres of Connellsville coal land and large ore properties. It already had partially under its control a fleet of twelve ore steamers. It now announced its intention to build large steel plants at Milwaukee and Pittsburg. The National Steel Company purchased iron mines and coal land and started to increase its furnace capacity. The National Tube Company began work on a large steel plant at Wheeling, West Virginia.

The completion of these projects meant heavy loss to the Carnegie Company and the Federal Steel Company. They were forced to fight back. The Federal Steel Company threatened to build wire mills unless the American Steel and Wire Company should abandon its proposed Milwaukee plant, and the threat for the time being proved effective. The Carnegie Company announced that it would construct a large tube mill at Conneaut, Ohio, and let it be understood that it would not hesitate to enter into active competition with all the producers of finished goods. There was no doubt in the minds of those who knew Andrew Carnegie but that these plans would actually be carried out. They recalled that "the wild Scotchman" had been successful in even more daring schemes.

The situation was full of dangers. The prosperity of the steel makers could not continue through the bitter competitive war that seemed to be in prospect. The officials of the Carnegie Company apparently were not seriously worried, for they felt confident of the ability of their organization to finance and make highly profitable in the end whatever new construction might become necessary. The officials of the other great companies, however, were not so complacent. All of the large con-

solidations were capitalized, as we shall see, up to the limit of their earning power, and their stock had been sold on the promise of large and regular dividends. Moreover, large amounts of the stock were still owned by the original promoters and underwriters. The managers, therefore, were far from eager to enter into a regime of severe competition. Under these conditions the suggestion that an immense holding company, the greatest trust in the world, be formed was favorably received. It furnished the only possible peaceful solution of the pending problems. The strongest financial houses, as well as the largest steel companies, were committed in advance to this plan, because it was the only means of protecting them from severe loss.

125. *Method of promotion.*—The promotion of the United States Steel Corporation was not, for the reasons that have been given, an especially difficult task. The chief obstacle was overcome when men of sufficient breadth, imagination and ability to form a clear conception of what was to be done had been found. So stupendous an undertaking could only be carried out by the giants of the financial the industrial and the legal worlds. Fortunately for the project, the right men were at hand and were interested in its success; above all, the active support of Mr. J. P. Morgan, the most forceful personality in Wall Street, did more than anything else to make the plan practicable and ultimately successful.

The details of the promotion of the United States Steel Corporation have never been disclosed. Long investigation was not as necessary as in most promotions for the reason that the promoters were familiar at first hand with the concerns to be consolidated. The plan at first, it is known, was to combine only the great com-

panies; the Carnegie Steel Company, Federal Steel Company, National Tube Company and the American Steel and Wire Company. The potential competition, however, of the four Moore companies looked so threatening that they also were brought into the combination. Certain other large companies, such as the Jones and Laughlin Steel Company, of Pittsburg, were approached, but no terms were agreed upon.

The United States Steel Corporation filed its certificate of incorporation in New Jorsey on February 23, 1901, showing a capitalization of $3,000. Under its amended certificate of April 1, 1901, however, its capitalization was changed to $1,100,000,000, one-half common and one-half preferred. The charter, it may be noted, gives discretion to the board of directors to increase its capital stock.

126. *Prospectus of the corporation.*—In the light of the later history of the company and as an example of scientific prospectus-making, some extracts from the prospectus issued by the firm of J. P. Morgan and Company are given below. The reader should note how carefully each positive statement is qualified and how much more is implied as to prospective profits than is actually said. Yet the prospectus cannot be called misleading. If it is read as carefully as it was written, it will be found not only to contain technically accurate statements, but to give a correct impression as well. The difficulty comes in the fact that comparatively few persons are capable of giving it a careful reading. The prospectus also contains a sufficient account for our purpose of the basis of consolidation.

A syndicate, comprising leading financial interests throughout the United States and Europe, of which the undersigned

are managers, has been formed by subscribers to the amount of $200,000,000 (including among such subscribers the undersigned and many large stockholders of the several companies), to carry out the arrangement hereinafter stated, and to provide the sum in cash and the financial support required for that purpose. Such syndicte, through the undersigned, has made a contract with the United States Steel Corporation under which the latter is to issue and deliver its preferred stock, and its common stock, and its 5 per cent gold bonds in consideration for stocks of the above-named companies and bonds and stock of the Carnegie Company and the sum of $25,000,000 in cash.

The syndicate has already arranged for the acquisition of substantially all the bonds and stock of the Carnegie Company, including Mr. Carnegie's holdings. The bonds of the United States Steel Corporation are to be used only to acquire bonds and 60 per cent of the stock of the Carnegie Company.

The syndicate offers for each $100 par value of stock of the class mentioned below, the amount set opposite thereto in preferred stock or common stock of the United States Steel Corporation at par:

Name of company and class of stock.	Amount of new stock to be delivered in par value.	
	Preferred Stock	Common Stock
Federal Steel Company:		
Preferred stock	$110.00	......
Common stock	4.00	$107.50
American Steel and Wire Company of New Jersey:		
Preferred stock	117.50	......
Common stock	......	102.50
National Tube Company:		
Preferred stock	125.00	......
Common stock	8.80	125.00

National Steel Company:		
Preferred stock	125.00	......
Common stock	......	125.00
American Tin Plate Company:		
Preferred stock	125.00	......
Common stock	20.00	125.00
American Steel Hoop Company:		
Preferred stock	100.00	......
Common stock	......	100.00
American Sheet Steel Company:		
Preferred stock	100.00	......
Common stock	......	100.00

With reference to the last four companies the aggregate amount of stocks so to be offered was arranged with the principal stockholders of those companies, who have requested the distribution of such amount among the four companies, to be made in the percentage above stated.

Statements furnished to us by officers of the several companies above named and of the Carnegie Company show that the aggregate of the net earnings of all the companies for the calendar year 1900 was amply sufficient to pay dividends on both classes of the new stocks, besides making provisions for sinking funds and maintenance of properties. It is expected that by the consummation of the proposed arrangement the necessity of large deductions heretofore made on account of expenditures for improvements will be avoided, the amount of earnings applicable to dividends will be substantially increased, and greater stability of investment will be assured, without necessarily increasing the prices of manufactured products.

All shares of the United States Steel Corporation deliverable to or for account of the syndicate, which shall not be required for the acquisition of the stock of the Carnegie Company or for delivery to depositors under terms of this circular, are to be retained by and to belong to the syndicate.

It is proper to state that J. P. Morgan & Co. are to receive no compensation for their services as syndicate managers be-

yond a share in any sum which ultimately may be realized by the syndicate.

J. P. Morgan & Co.,
Syndicate Managers.

127. *Profits of the promoters.*—The sum which ultimately was realized by the syndicate was never made public, but it is easy to figure that it must have been in neighborhood of $240,000,0000, face value, of common stock, against which should be off-set $25,000,000 cash furnished by the syndicate and the expenses of promotion. Assuming that the common stock was sold by the syndicate members at an average price of thirty, which is probably lower than the actual average, we have gross profits of $72,000,000. Deducting the $25,000,000 and assuming expenses to have been $1,000,000, we have left net promoters' and underwriters' profits of $46,000,000—a huge sum and yet not too great, considering the risk and financial power and abilitv required in the unprecedented undertaking.

The provision of cash by the syndicate was a somewhat unusual method of meeting this part of the financial problem involved in promoting a consolidation.

128. *Capitalization at the beginning.*—It is worth noting that the $160,000,000 Carnegie stock obtained in exchange $98,000,000 preferred stock, $90,000,000 common stock and $144,000,000 bonds of the Steel Corporation. In addition $160,000,000 Carnegie bonds obtained an equal amount of United States Steel collateral bonds. Thus the par value of the stocks and bonds given to Carnegie Company security holders was nearly one-half billion dollars, more than one-third the total capitalization of the corporation. The aggregate capitalization of the other seven original companies was $457,000,000 and the par value of Steel stock given in

exchange was $532,000,000, an increase of $75,000,000. The terms of exchange were so liberal that 98 per cent of the stock of the original eight companies was acquired.

Shortly afterwards two other companies were taken in, namely:

1. The American Bridge Company which had been formed in April, 1900. This company had absorbed twenty-six separate concerns and embraced over nine-tenths of the bridge-building interests of the United States.

2. The Lake Superior Consolidated Iron Mines Company, which owned and operated valuable mines in the Mesaba range of the Lake Superior iron region.

Practically all the securities of the Lake Superior Company were acquired and 85 per cent of the stock of the American Bridge Company.

The capitalization of the United States Steel Corporation at the end of the first year was as follows:

Capital Stock, Preferred	$ 510,281,100.00
" " Common	508,302,500.00
Capital Stock of Subsidiary Cos., outstanding	215,914.88
U. S. Steel Bonds	303,757,000.00
Other bonds	56,997,326.00
	$1,379,553,840.88

The figures following will give some idea of the enormous extent of the steel corporation's property at the beginning: 213 different plants and transportation companies; 41 mines; nearly 1,000 miles of railroad; a lake fleet of 112 vessels which constituted one-third total tonnage of Northern Lakes; controlled 78 blast furnaces, one-third of the number in United States; owned

57,000 acres of coking coal land; leased 50,000 acres Pocahontas Coal land, W. Va.; owned considerable areas of steam and gas coal in Illinois. The most important assets of all were the ore deposits in the Lake Superior region, which were estimated by Mr. Schwab at 750,000,000 tons.

129. *Additions.*—The principal additions to the steel corporation have been:

1—Shelby Tube Co.	1901
2—Union Steel Co.	1902
3—Holdings of Chemung Iron Co., Duluth	1903
4—Properties of Clairton Steel Co.	1904
5—Lease of Hill Holdings in Lake Superior Region	1906
6—Tennessee Coal, Iron and Railroad Company	1907

The Shelby Steel Tube Company was a small and greatly over-capitalized concern which was, however, the largest maker of seamless tubing in the world.

The Union Steel Company was a consolidation of seven coke-mining, sheet steel, tin plate and steel companies in and near Sharon, Penna.

The Chemung Iron Company was a Detroit concern which owned a large and important block of Mesaba ore deposits.

The Clairton Steel Company was a Pittsburg concern which owned a large plant, 2,600 acres of coking coal land, 20,000 acres of mineral lands in the Marquette Range and considerable railroad and limestone properties.

On April 15, 1907, the notable lease of the Hill ore lands was ratified. The lease provides that a royalty of $1.65 per gross ton for ore of a fixed grade was to be paid in 1907 and the royalty increased 3 4-10 cents per ton each succeeding year. The minimum to be mined

and shipped was 750,000 tons in 1907 and was to increase 750,000 tons per year until it reached 8,250,000 tons. The option was reserved, however, to the Steel Corporation to end the lease in 1915, and in 1912 the approaching termination of the lease was announced.

In November, 1907, the corporation acquired about $30,000,000, or practically all, of the outstanding common stock of the Tennessee Coal, Iron and Railroad Company. The stock was paid for at the rate of $11,904.76 par value of the 10-60 year sinking fund 5 per cent bonds of the steel corporation for $10,000 par of Tennessee common. Many readers no doubt will recall the circumstances surrounding this deal. It was made possibly by the ability of the Steel Corporation to put up ready cash in the critical time of the October, 1907, crisis. The cash was used to buy in the Steel Corporation's own bonds with which to pay for Tennessee stock. The operation thus had a double effect of supplying cash to persons who needed it badly, and of supplying a security, which was acceptable as collateral, in place of the unavailable Tennessee stock. The Tennessee Company owned 16 blast furnaces, 450,000 acres of coal, ore and limestone and timber lands, large developed coal mines and a big steel rail mill at Ensley, Ala.

Besides these large purchases the steel corporation has also increased its holdings by building out of its earnings an entirely new plant. At Gary, Indiana, there has been erected a large modern steel rail mill at a cost of $75,000,000. The mill began operations in 1909. The Gary tract covers about 9,000 acres, of which 1,163 acres are devoted to the plant. The cost was nearly $80,000,000. This new plant was called for by the great increase in the western demand for steel.

130. ***Financial changes.***—The chief event in the financial history of the Steel Corporation is its much discussed preferred stock conversion of 1902. In April of that year the management issued a circular to stock holders saying that \$50,000,000 new capital was needed, one-half for redemption of temporary loans incurred by constituent companies and one-half for improvements. The plan proposed was to create a new issue of \$250,-000,000 5 per cent bonds, of which \$200,000,000 was to be exchanged, dollar for dollar, for an equal amount of preferred stock and \$50,000,000 was to be sold for cash. Each preferred stockholder was offered the right to subscribe to the extent of one-half his holdings, paying 40 per cent in stock and 10 per cent in cash, or to the extent of 40 per cent of his holdings, paying in stock alone. The argument urged for this plan was that the \$50,000,-000 would be raised and yet an annual saving in the company's charges of \$1,500,000 would be effected. To this plan 99 8-10 per cent of the stock voted at the annual meeting assented.

The plan was objectionable, however, to certain stockholders for the obvious reason that a new issue was created superior to their own security without any corresponding enhancement in the value of the corporation's assets. The plan was further objectionable in that the issue was to be underwritten by a syndicate which included some of the corporation's directors. The syndicate agreed to take enough of the bonds to bring the total sale up to \$100,000,000.[1] In return they were to have the privilege of subscribing to any or all of the bonds not taken by the stockholders and they were to get a 4 per cent commission on all the bonds sold to the stockholders or otherwise. It was objected that under

[1] See a copy of the agreement in Chapter XIX.

this agreement the syndicate took a very slight risk inasmuch as it was practically certain that at least $100,000,000 worth of bonds would be sold, and got an excessive commission. The objections on this score were never satisfactorily answered.

The opponents of the conversion plan secured a temporary injunction and brought suit to restrain the directors from carrying out the plan. The decisions of the court, however, were in favor of the Steel Corporation management, on the ground that no fraud was shown and that the great majority of the stockholders had approved the issue. The danger of disaster to the corporation, on account of its great increase in bonded obligations, is somewhat lessened by the fact that the interest on these sinking fund 5's must lapse for two years before foreclosure proceedings can be commenced. This provision is a safeguard to the corporation, though, of course, it would not be of great value in a period of prolonged depression like that from 1893 to 1897.

The slump in the steel business in 1903 made it necessary for the corporation to economize. Several mills were dismantled and some of the sub-executive offices were abolished. It became desirable to change somewhat the financial organization of the corporation. In March, 1903, the original Carnegie Company of Pennsylvania, the National Steel Company and the American Steel Hoop Company were combined under the name of the Carnegie Steel Company of New Jersey and later in the year the American Sheet Steel Company and the American Tin Plate Company were combined as the American Sheet and Tin Plate Company. Early the next year the corporation's search for wider markets led to the formation of the United States Steel Products Export Company, which is the selling agency for all

the foreign business of the corporation. The direct control of this company is in the Federal Steel Company.

131. ***Basis of capitalization.***—Is the steel corporation over-capitalized? It is not worth while to rehash the wordy debate on this question, which has lasted for several years, but a few facts ought to be noted. The aggregate capitalization of the first ten companies to enter the corporation was approximately $710,000,000. In exchange for this amount of stock the corporation issued $868,000,000 stock and $144,000,000 bonds, an increase of $302,000,000. In addition the promoters of the steel corporation received for their services something over $240,000,000 in stock. Even though we should estimate that all the subsidiary companies' stock represented tangible assets, therefore, we should still have to conclude that $542,000,000 of the United States Steel capitalization was water at the start.

But what are the facts as to the capitalization of the original companies? Daniel G. Reid, president of the American Tin Plate Company, testified before the Industrial Commission that of the $46,000,000 capitalization of that company, $18,000,000 (preferred stock) was supposed to represent the value of the property and $28,000,000 (common stock) represented hopes for the future and the pay of the promoter. It is well known that in the capitalization of the National Steel, American Steel Hoop and American Sheet Steel companies, all of which were promoted by the same interests as the American Tin Plate Company, the same principle was followed.

Similarly, Mr. John W. Gates testified that of the $80,000,000 capitalization of the American Steel and Wire Company, $20,000,000 to $30,000,000 was water. Of the $100,000,000 capitalization of the Federal Steel

Company, about $45,000,000 represented tangible assets and $10,000,000 cash assets, while the rest was water. These statements are enough to indicate that of the $710,000,000 capitalization of the original companies, a large share stood for nothing more tangible than good will and "prospects."

The suits to prevent the carrying out of the preferred stock conversion plan of 1903 brought out some interesting statements. One affidavit, by an engineer who was represented as an expert, said that the plants and properties of the corporation could be duplicated for about $200,000,000 and that the total assets, including good will and organization, were not worth $500,000,000. Another affidavit stated that the plants of the Carnegie Company, represented 44 per cent of the productive capacity of the steel corporation and that these plants had been valued on March 12, 1900, by the partners of the Carnegie Company in a legal proceeding at $75,000,000. On the other hand, Mr. Charles M. Schwab, then president of the steel corporation, submitted the following valuation:

1—Iron-ore Properties	$ 700,000,000
2—Plants, Mills, Fixtures, Equipments	300,000,000
3—Coal and coke fields, 87,589 acres	100,000,000
4—Transportation properties	80,000,000
5—Blast Furnaces	48,000,000
6—Natural Gas Fields	20,000,000
7—Lime Stone Properties	4,000,000
8—Cash and cash assets	214,278,000
	$1,466,278,000

There is not such a great difference between these two estimates as at first appears. More than one-half the assets, as given by Mr. Schwab, consist of ore and

coal land in which he included unmined ore at a high value. Beyond question, such an estimate is uncertain and speculative. Technical progress may introduce new methods of treating ore which will greatly reduce the value of this large buried mass. Besides, Mr. Schwab had already counted the value of this ore once when he based his estimate of the value of the plants on their low cost of production and, as a factor in that low cost, counted in the cheapness with which they could secure raw materials.

In what has been said it has been assumed that the proper way to value a property is to arrive at the probable cost of replacing it. But there is another method of valuation which is more popular among business men, and, to the writer's mind, more scientific. This method is to capitalize earning power. The profits of the eight original sub-companies of the Steel Corporation in 1900 were $96,000,000. The record of the Steel Corporation in the first seven years of its history was as follows:

	Net Earnings
1902	$133,308,000
1903	109,171,000
1904	73,176,000
1905	119,787,000
1906	156,624,000
1907	160,965,000
1908	91,267,000
Average	$120,614,000

Now if we assume that 10 per cent is a fair rate on money invested in the steel business and capitalize profits on that basis, we get a result not a great deal below the present capitalization.

Our general conclusion on this point must be something like this: If the properties of the Steel Corporation were sold under the hammer, they probably would not fetch one-half or one-third the amount at which the corporation is capitalized. Even if we take into consideration good will. organization, financial connections, and so on, we could hardly say that the assets equal or nearly equal the capitalization. But, if we base our valuation on earnings, not assets, we can safely say that the over-capitalization is not very great.

The Steel Corporation is earning immense sums because it is well managed; because it has prestige; because in some lines it has almost a complete monoply. These things are not tangible assets, but they are sources of income; and income, according to ordinary business usage may properly be capitalized.

Even from the ultra-conservative standpoint, it may be said that the Steel Corporation is rapidly "squeezing out the water" for it has made it its policy to provide from its gross income for depreciation and for improvements. The figures following show that about $300,-000,000 have thus been added to the tangible assets of the corporation since its formation.

Sinking Funds, subsidiary companies	$ 9,367,412
Sinking Funds, U. S. Steel Bonds	25,624,410
New Construction	176,137,166
Increase in surplus	82,223,107
	$293,352,095

132. *Operating policy.*– A careful study of the operating policy of the Steel Corporation belongs elsewere. Our attention may be turned, however, to a few conspicuous facts.

The corporation's relations with its employés have so far been exceptionally harmonious. There has been no strike or serious trouble of any kind. At the end of 1902 the corporation started its famous profit-sharing plan under which a large amount of preferred stock has been sold to employees. The workers are divided into six classes, according to salary, and each class is allowed to buy a certain proportion of stock each year at a fixed price. The prices named have always been somewhat below the market prices. The corporation gives a bonus of $5 for each share which is held for five years. The result has been to give a considerable number of the 210,000 employees a lively interest in the success of the corporation, and to bind them more closely to the management. The scheme has proved practicable and has been probably of great benefit in maintaining industrial peace.

The corporation is, of course, simply a holding company and has only a general oversight over the sub-companies. Each subsidiary company manages its own internal affairs and buys and sells from and even competes with other sub-companies. Cross shipments, however, are avoided and raw materials are furnished by common agencies. The idea is to stimulate each company by internal competition and otherwise to the highest pitch of efficiency. The operating ratio or per cent of manufacturing costs to gross business has been very steady with a slight tendency downward since 1902. The ratio has not moved up very high in periods of depression, which is considered an indication of economical management.

133. *Steel securities.*—The securities of the United States Steel Corporation now outstanding are:

1—Underlying bonds	$ 160,877,877
2—Coll. Tr. Gold 5's, 1901	270,277,000
3— " " Skg. Fd. 5's, 1903	189,346,500
Total Bonds	$ 620,501,377
4—Preferred Stock	360,281,100
5—Common Stock	508,302,500
Total Securities	$1,489,084,977

The underlying bond issues are too numerous and too small in volume to be worth discussing here. Most of them are secured by direct first mortgages and are very closely held.

The collateral trust gold 5's of 1901, due April 1, 1951, are secured by the deposit of all the securities owned by the corporation. A sinking fund of $3,040,000 per year is used to purchase bonds obtainable at 115 or less, and since August 1, 1911, has been applied to the redemption of the bonds drawn by lot. Almost all these bonds are held, it is understood, by Andrew Carnegie and are not on the market.

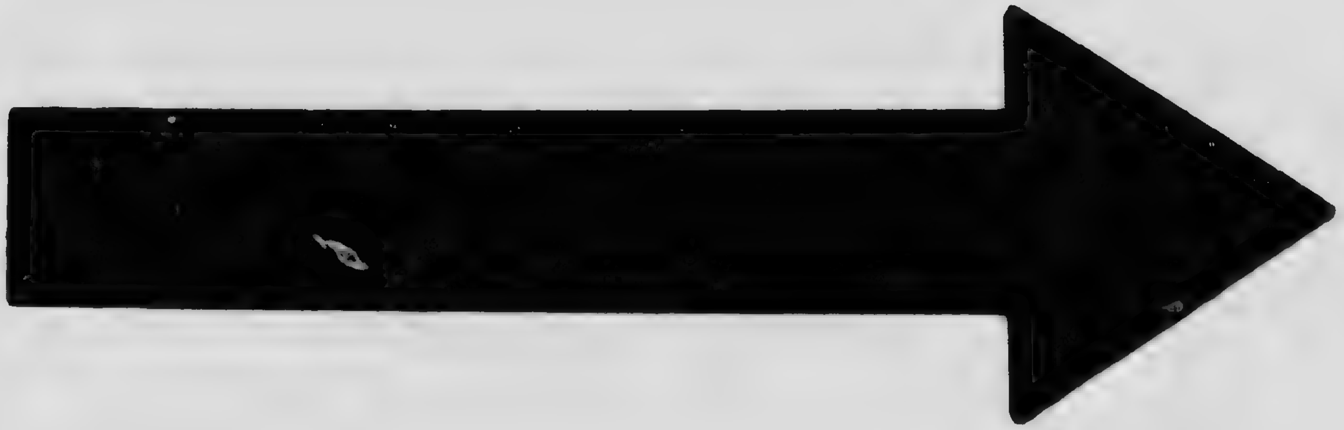
A more interesting issue to us is the collateral trust sinking fund 10-60 year gold 5's of 1903. The authorized issue was $250,000,000, of which $200,000,000 was reserved for exchange with preferred stock under the conversion plan. As a claim on the assets, these bonds rank next to the 5's of 1901. They are further protected by a sinking fund of $1,010,000 per annum to be used until 1913 for the purchase of bonds at 110 or less and after 1913 for the redemption of bonds, drawn by lot, at 110. This last named feature introduces a speculative element into the security which is supposed to enhance its value. If the estimates already quoted of the asset value of the property of the corporation are

correct, these bonds have behind them chiefly the earning power of the corporation.

The preferred stock issue is 7 per cent cumulative. Dividends have not been missed since the formation of the corporation. The common stock drew 4 per cent in the first two years; ½ per cent in 1903; nothing from that date till 1906; 1½ per cent in 1906; 2 per cent until 1909, when 4 per cent was paid, and 5 per cent since 1909.

Steel has been a prince now for several years. Is it likely to become so much of a pauper that dividends or even interest will be threatened? There can be no doubt but that the corporation is still in danger; a bad slump or even insolvency is conceivable. On the other hand, there are at least two good reasons for believing that the danger is rapidly lessening and in a few years will be a thing of the past.

One of these reasons is that the physical condition of its properties is excellent, according to all reports, and is being constantly improved. We have already alluded to the large appropriations for depreciation and for betterments. It is estimated that following the completion of the Gary plant, the capacity of the corporation was increased about 75 per cent; yet the interest charges are practically the same as they were at the beginning. In addition, new ore deposits, it is said, of a value of $400,000,000 have been located on the lands of the Steel corporation. The second reason is that the demand for steel in this country is apparently insatiable. Steel rail production to-day is nearly three times that of 1881; yet this particular kind of product which was of great importance in 1881 is now only a fraction of the entire steel trade. The demand for structural shapes and for machinery, already enormous, is just beginning to grow.



MICROCOPY RESOLUTION TEST CHART

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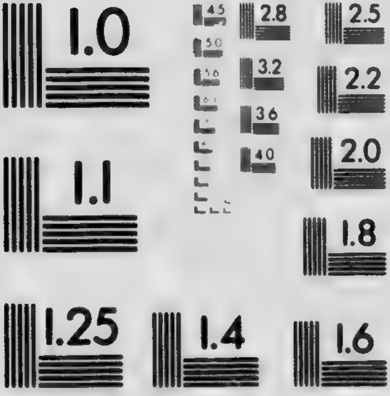

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To get an idea of what may be expected in the next ten or twenty years, let us observe the per capita increase in the production of pig iron in the last three decades as shown below:

1880	171	pounds
1890	329	"
1900	399	"
1905	619	"
1910	669	"

If the steel business, then, grows, as the biggest and most farsighted men in that line expect, and if the present policy of improving and enlarging the properties continues, as there is no reason to doubt, we may safely conclude that the earnings of the Steel Corporation will become very much larger than they are now. Of course, those earnings will not grow continuously. The steel business is speculative and erratic in its very nature and always will be, so long as periods of depression and of prosperity alternate. Yet the enterprise and efficiency of the United States Steel managers seem to be almost a guarantee that at the worst steel earnings will never sink so low that interest charges cannot be met; it is reasonable to expect that they will never sink so low that preferred dividends cannot be met; and it is even reasonable to hope that the common dividends will always be maintained at or above their present level.

CHAPTER XVI

SELLING SECURITIES—THE PROSPECTUS

134. *The four methods of selling securities.*—Whenever new securities—whether of an established company, of a new concern or of a reorganization—are issued, these are four possible methods of disposing of them. The first method is by an inside distribution of the securities to people already interested in the business. This method we have already considered. In the case of a close corporation the distribution of the securities is obviously a simple matter of bargain-making among the few people involved. In the case of a consolidation the distribution to insiders is carried on by exchanging the new securities for old securities as already explained.

The second method is to work through the Wall Street, or some similar market, which is considered in the chapter following.

The third method is to sell them to the public through established bond or brokerage houses. This method will be discussed both in this chapter and under the head of underwriting.

The fourth method is by direct appeal to the public through newspaper and magazine advertising, through circular and individual letters and through salesmen. In a great many corporations the promoter finds the first three methods unavailable and is forced to resort to this fourth method. This is particularly true of speculative enterprises.

The principles that should be followed in the presen-

tation and selling of corporate securities direct to the public are not different from the principles that should be followed in selling other articles. These principles are treated in the treatise on SELLING AND BUYING and need not be reviewed here. Something should be said, however, about the document in which the leading facts with regard to the securities are stated and the prospects of the company discussed, namely, the prospectus.

135. *General characteristics of a good prospectus.*—The promoter's prospectus should be, and with successful flotations usually is a work of art. A good prospectus will appeal to a large number of people, will arouse their interest, will hold their attention from beginning to end, and will engender confidence. A poor prospectus will nullify whatever success the promoter may have had in stimulating curiosity on the part of the prospective buyers of his securities.

It goes without saying that it should be well written and attractively printed. In this respect the same rules that apply to other selling literature should be followed.

Naturally the prospectus will emphasize the strong features and minimize the weak spots of the business. The promoter must take care, however, in so doing that he does not misstate or conceal any material fact. Otherwise he may be held liable for fraud, or at least anyone who subscribes to the corporation's securities on the strength of the prospectus may have good legal grounds for withdrawing from his contract. The skillful prospectus writer, who is presenting to the public securities which he knows to be highly speculative in character, must find some means of reconciling these apparently inconsistent requirements. He must present all the important facts and yet he must make his prospectus strong, attractive and convincing. Any

well-trained writer should be able to do the trick if he studies his proposition carefully.

Obviously in any prospectus the strikingly attractive features of the enterprise will be made prominent and much will be said about them. Perhaps the statements with regard to them will be printed in bold face or other prominent type, so as to catch the eye of the reader at once. Statements as to the more doubtful and risky features of the enterprise will be tucked away in some obscure corner. Thus the law will be satisfied and at the same time it will take a very careful, intelligent reading to ascertain from the prospectus the real facts of the case.

Another means of avoiding legal objections is to make sweeping general statements without making the writer or any other definite person responsible for them. Such phrases as "competent judges have reported," or "after expert examination we believe," or "witnesses who have seen the property are thoroughly convinced," are very common introductions in prospectuses. The statements in themselves may be untrue; yet by using such phrases the writer may succeed in divesting himself of any personal responsibility.

Most prospectuses, as any reader of them will testify, are so vague, that what the writer implies assumes a much more prominent place in the average reader's mind than what he actually says. In a recent mining prospectus, for instance, we have the following typical sentence: "We have every reason to believe that the corporation will have assets at the end of the year that will astonish each and every holder of the stock, and it is our belief that claims, titles and rights cannot be bought outright for $1,000,000 or more." Notice that this sentence does not contain any single statement of

fact to which the prospectus-writer could be bound down.

Another hoary trick that is worked over and over again in the prospectuses of new companies, is to call attention to the immense profits of other companies working in the same filed. It is very seldom indeed that a copper-mining prospectus is issued that does not call attention in big type to the profits made by the holders of the original stock of Calumet and Hecla, the Copper Queen, Anaconda, and other classic examples. The reader is expected to infer that the new corporation will have a similar history.

136. *A typical speculative prospectus.*—The prospectus of a company designed to own and publish a magazine is given in part below. The reader will find in these few paragraphs illustrations of all the principles mentioned above. In this case, although the magazine is stated to have been in existence for twenty-eight years, not one word is said as to its record; instead, all the emphasis is given to "prospects," "purpose" and "possibilities."

It is a medium that can treat any subject with justice to itself and its readers; therefore, its pulling power for subscriptions, you will agree, covers possibly a greater field for circulation, than any magazine that you can recall. Its field of expansion is simply unlimited.

From an advertising standpoint, I might say, after years of experience, I do not know of a publication that has such prospects for money making as The Blank Company.

Being a practical publisher, it is my purpose to put The Blank Company in the place it should enjoy, and in order to do this, I have deemed it wise to share its future with a number of my friends, and am, therefore, organizing a company capitalized at $50,000 for the immediate expansion of The Blank Company. The stock is secured by the property, the name and the good will, which, if put up at auction, would be considered a

bargain, if purchased at many times the amount of the company's capitalization.

If you have looked into the magazine field, you will know that although some of the larger magazines are capitalized for over a half-million dollars, they are all making phenomenal money for their early investors. The general magazine field I consider pretty well covered, but a magazine of the unique name that The Blank Company possesses, can be expanded and developed and larger profits made from it than any other publication enjoys.

To illustrate the earning power of magazines, permit me to say that one magazine was sold some time ago to a well-known newspaper publisher for nearly $700,000, in spite of the fact that at that time it had a circulation of only 250,000 and a shrinking in its advertising patronage.

Another well-known magazine, whose circulation had dropped down below 50,000 and had practically no advertising, declined an offer of $10,000 for its name and good will.

I will recall that if you had been able to buy a thousand dollars worth of *Munsey's* stock, on the ground floor basis (that you are now offered in The Blank Company) for your investment the thousand dollars in *Munsey's* now would be paying you $10,000 to $12,000 a year in dividends.

If you could have invested only $100 in *Munsey's*, your holdings would now be worth from ten to twelve thousand dollars and would be paying you $1,000 to $1,200 a year in dividends; a larger investment would have made you wealthy.

An English author, who ten years ago obtained $2,000 worth of *McClure's* Magazine stock in exchange for a manuscript, sold his holdings recently for $20,000, having received in dividends during that time the round sum of $14,000. For his $2,000 worth of manuscript he received in a decade $34,000 in cash, a profit of 1,700 per cent.

Everybody's, *The Ladies' Home Journal* and many other magazines, represent wonderful money-making investments.

The same opportunity is knocking at your door at this moment. The Blank Company with its twenty-eight years of continuous existence, with an unlimited alvertising field and with

a subscription list that can be increased beyond that of any other publication in existence, offers you a rare opportunity in associating yourself with an enterprise which will make money for its stockholders very rapidly.

If you want to go in with me in developing and expanding The Blank Company, I will offer you some of its stock at its par value, $10 per share. This opportunity, however, will only remain open for a short while. Stock can be purchased on a basis of 8 per cent for cash with subscription, or 10 per cent down and 10 per cent per month.

137. *A typical investment prospectus.*—In the above remarks we have had in mind principally the prospectuses of highly speculative companies. We need not pass judgment here on the legitimacy of the methods that are used by such companies to obtain subscriptions for their stock. It is certainly improper to delude subscribers. On the other hand, it is unquestionably proper to present a new enterprise in a favorable light. Just where the dividing line between an honestly favorable and a dishonestly deceptive presentation comes is a question which every promoter must settle with his own conscience. The prospectuses of well-known, entirely legitimate investment securities often go to the other extreme. They present merely a dry, formal statement of the facts with sometimes a tabulation of the assets and earnings of the company or bald figures of some other kind.

For instance, several of the leading banks of the world—including Baring Brothers and Company of London, Comptoir National d'Escompte de Paris, Credit Lyonnais of Paris, Deutsche Bank of Berlin, J. P. Morgan and Company, the First National Bank and the National City Bank of New York—co-operated in issuing on March 1, 1909, a $50,000,000 5 per cent

internal gold loan of the Argentine Government. Much might have been said as to the wealth, high standing and prospects of the Argentine Republic and as to the small amount of the loan in comparison with the great resources back of it. The bonds were sold at the price of 99 per cent of the face value, thus yielding to the purchaser something over 5 per cent, a high rate on the loans of a government of good standing. We can imagine, taking the examples that have been given above as a basis, how a promoter used to getting up prospectuses for speculative concerns would have reveled in the opportunities that this issue would have afforded him, how he would have enlarged on the Argentine Republic's reputation and prosperity, how many word pictures he would have drawn to illustrate his statements.

The prospectus issued by the great banks that have been named, however, compressed a description of the bonds, a statement of the terms on which they would be issued, and the argument on behalf of the bonds into the four brief, cold paragraphs that follow:

Provision is made for a sinking fund of 1 per cent. By the operation of this sinking fund the loan will be paid off in thirty-six years at the latest. The contract with the Argentine Government provides that said fund is to be applied half yearly to the purchase or tender of bonds at or under par or by drawings at par should the bonds be at over par. The first operation of the sinking fund will take place in the month of December, 1909. Drawn bonds will be payable on March 1st or September 1st following the date of the drawing. The Government undertakes not to increase the sinking fund or to redeem the whole of the loan before March 1st, 1914.

We reserve to ourselves the absolute right in our discretion to close the application list at any time without notice and to

reject any or all applications and also to allot smaller amounts than applied for.

All applications should be made on forms which may be obtained at our offices, and must be accompanied by a deposit of $50 per bond.

If no allotment is made, the deposit will be returned in full, and if only a portion of the amount applied for be allotted, the balance of the deposit will be appropriated towards the amount due on March 10th, 1909. If any further balance remains, such balance will be returned. In case of failure to pay the balance of the subscription when due, all right in any previous payment will vest in us absolutely without accountability therefor.

Although such a presentation is unattractive, it is frequently effective. The coldness and dryness carry with them the sense of conservative safety. For that reason, a statement of this kind is sometimes put forward as a prospectus of what is in reality a highly speculative company; and this trick when skillfully executed has been known to succeed.

138. *The ideal prospectus.*—Even in the most formal prospectus, however, it is usually well to use untechnical expressions and to present facts in such a manner that they will be not merely significant, but interesting. Some such tendency is coming into evidence, even in the presentations of strictly investment securities. The number of people who are possible investors in such securities is constantly increasing and the amount of such securities is also increasing. In order to create a market for these immense issues among people who are not familiar with the technical jargon of the financial world, it is necessary to change somewhat the old-fashioned formal method of presentation. This change is undoubtedly for the better. As the intelligent in-

terest of the public in financial affairs grows, we may expect to see the typical prospectus of a speculative corporation and the presentation of a strictly investment security approaching each other more closely in tone and in form.

Athough in this country the prospectus, as has been indicated, is so frequently used to present speculative and even swindling schemes in a false light that prospectus-writing has come to be regarded almost as a dishonorable method of securing money for an enterprise, and although this opinion is not without basis, yet it must be borne in mind, on the other hand, that there are such things as a legitimate direct appeal to the public for funds and an honest prospectus.

In England this method of raising funds is much more generally used for reputable enterprises than in this country. To take one instance, it is said that the English Eastman Kodak Company was floated without any assistance whatever from bankers or underwriters. About $5,000,000 of stock was sold to the public through direct newspaper advertising, circularizing and the issue of an attractive prospectus. That the method in this instance has been entirely successful is shown by the fact that the company's stock is now selling at the rate of about $675 a share. It is to be regretted that the number of similar instances in this country is so small.

139. *Selling through banking houses.*—The securities of almost all large legitimate corporations are sold through banks and brokerage houses. The advantage of this method to the investor is that he is protected more or less by the investigation and experienced judgment of his banker. The disadvantages are three: first, on account of his leaving the investigation to the banker he

does not acquire that first-hand knowledge of the enterprise in which he invests that it would be desirable for him to obtain; second, that he is thus left practically at the mercy of his banker; third, that the broker's commission, which is often not inconsiderable, intervenes between the buyer of the security and the selling corporation.

The advantage to the corporation of selling through a bank or brokerage house is that the corporation officials may feel certain that the issue will be successfully disposed of in this way, especially if it is "underwritten," as explained in Chapter XVIII. With a corporation of any size, the bond or brokerage house will probably be one of the large concerns that carry on their work in the Wall Street district of New York, the State Street district of Boston, the La Salle Street district of Chicago, or the corresponding financial center of some other large city.

140. *Requirements of reputable banking houses.*—The good Wall Street houses will not undertake to float issues of small size—certainly none less than $100,000 and preferably not that small—for two reasons; first, because there is not enough profit in selling small issues to pay for the expenses; second, because a small issue of stocks or bonds never becomes well-known to the public and is therefore not readily marketable. As to the kinds of enterprises that will be taken up, the better houses prefer in the order named, steam railroads, electric railroads and industrials. Most of them will not touch mines, oil companies, or any other highly speculative enterprise. The only practicable means for getting funds for such an enterprise from the public ordinarily is by direct solicitation.

There are not many high-class Wall Street houses

engaged in selling securiti and there are a considerable number of imitation banking houses whose main object is to get their hands on the money of "suckers." The working plan of such swindlers is to receive persons who come to them with securities to sell, no matter how worthless the securities may be, with open arms, wax enthusiastic over the market for the securities, make numerous high-sounding promises as to the sales which they will be able to make, and in conclusion demand from the victim as his "guarantee of good faith" a sum of money for expenses. Of course this money is not honestly spent. The high-grade banking houses, on the contrary, will receive any new proposition that is presented to them, especially if it comes from a stranger, with skepticism; and, if they show any interest at all, it is to be expected that they will make a long and thorough investigation, before committing themselves in any manner. It is poor policy to approach one of these houses without having a business introduction of some kind. Generally speaking, it is well to present the proposition in writing in the first place, giving a clear and complete statement with all the supporting evidence that can be added. A Wall Street banker of the class that the writer has in mind is not likely to be carried off his feet by persuasive personal eloquence and is more likely to yield to cold figures than to impassioned appeals.

It takes a man who has spent a lifetime in the Street to tell absolutely what are the sound, reliable houses and what are the more or less shady concerns. There are Wall Street firms which, to the writer's knowledge, are regarded by Wall Street bankers as worse than banditti, which nevertheless have kept in existence and have apparently been prosperous for many years. Such

firms may maintain expensive suites of offices, may have pious-looking personages at their head and may give an appearance of permanence and honesty. The only sure sign of their general unreliability, that the writer can give, is that they are out looking for business, that they make an effort to secure for themselves the flotation of securities of small corporations and that they are willing to pretend to sell such securities without having first made an adequate investigation. Even this symptom, however is not always present, for the heads of such concerns are shrewd and experienced enough to make a pretense at times of conducting an investigation before they accept the proposition that has been presented to them.

The first step in the investigation of an enterprise by a reputable house will be to get the complete record of all the men who have any connection with it. If there is a flaw in the reputation of any of them, the whole proposition will probably be dropped. Next, the prospects of the enterprise itself will be looked into. Every large house engaged in selling securities keeps on its own staff capable men who are qualified to form an expert judgment as to the merits of the common forms of business enterprises, such as street railroads, manufacturing plants, and so on. In addition, unless the house is absolutely satisfied, it will probably obtain reports based on searching examinations by three classes of professional experts, namely, engineers, lawyers and accountants. If all of these are favorable, from beginning to end, the proposition will perhaps be accepted.

The three essential factors in making a proposition acceptable are:

(1) Good reputation of the men connected with the enterprise.

(2) Absence of risky factors in the general nature of the business or in the general situation. For instance, a street railway company would not be taken up if the people of the locality in which it had been located were for some reason bitterly hostile to public service corporations. In the same way, as has been said, the good banking houses will not deal in the securities of undeveloped mines, no matter how promising.

(3) Practical certainty of profits sufficient to meet all fixed charges. This almost goes without saying; yet it is worth noting, because many people seem to imagine that if a new corporation promises to have considerable profits its securities are safe investments. It is necessary that these profits should not only be large in the aggregate, but should be steady enough and certain enough to guarantee that the corporation will never be compelled to pass any of its interest payments or other fixed charges.

141. *Their methods of selling securities.*—The good Wall Street houses are so exceedingly careful in their investigations because they sell most of the securities they handle, not to the public at large through advertising and through wide distribution of prospectuses, but to a comparatively small number of their clients. These clients include not only indivduals, some of whom have regular sums to invest every year, but also such institutions as insurance companies, saving banks and trust companies. It is necessary in order to hold this clientele that the house should establish and maintain a reputation for the strictest integrity and conservatism. So long as this reputation is maintained there is seldom any difficulty in selling whatever securities the house may accept. The following extract from an article in

the "Bond Buyers' Dictionary" gives further details as to the methods of such houses.

It is through the retail bond dealers that the great investing public of the country is reached. The other day a retired merchant died in Pittsburgh whose wealth was estimated by bankers to exceed $50,000,000. Of the several million persons who read of his death in the newspaper the following morning only a few had ever heard his name before. There are thousands of similar capitalists in the United States, each possessing a fortune greater than was owned by any single individual in the country fifty years ago, whose names are entirely unknown to the average newspaper reader. There are several hundred thousand others who possess independent fortunes. It is with these individual investors that the retail bond merchant deals. All have a large list of wealthy customers, to which they are continually adding. The customers of some are mostly in New York or Pennsylvania, of others in New England, of other in Canada, of others in the West or the South. Some have wealthy foreign customers.

The number of regular customers may range from 5,000 to as high as 25,000. There is one retail bond house in Wall Street, which has been in business for seventy-five years, that has a list which could not be purchased for several million dollars. It includes 22,000 names, and these customers purchase, on an average, nearly $5,000 of bonds a year apiece, or a total of more than $100,000,000 a year. This house would not hesitate to purchase a block of $5,000,000 or $10,000,00 or even $20,000,000, of municipal, county, or railroad bonds, knowing that it would be able to dispose of the entire block in the course of a few months in small lots to its regular customers.

Practically every large retail bond house in Wall Street now employes salesmen, who travel over the country selling bonds, very much as drummers sell tea or coffee. Some of the largest houses employ as many as forty salesmen; altogether, more than 800 are employed in Wall Street. Each has his own territory and possesses his own customers. Many make salaries of from

$10,000 to $15,000 a year, and some even more. All are, to some extent, experts on values. In addition to employing salesmen the retail bond houses advertise extensively.

The reputation of a bond house, and the following which it possesses of the customers of a bond house purchase securities from it, not because of personal and expert knowledge of the security and safety of the bonds, but because of the reputation of the house. The average investor whether he invests $5,000 or $500,000 a year, after a superficial examination, purchases securities almost entirely on the recommendation of his bond dealer. The enormous profits the bond dealers make is the price they charge for lending this credit to corporations and municipalities. Practically every one of the leading Wall Street bond houses may boast that no investor has necessarily ever lost a single dollar through the purchase of bonds on their recommendation. With such a record, is it any wonder that, when such a bond house offers a block of bonds for sale, accompanied by a recommendation, that the entire issue is often oversubscribed within twenty-four hours of the opening of the books?

The profit of the banking house may take one of two forms, either a commission on the sales or the difference between the price at which it buys the securities and the price at which it sells them. Commission is more common and is regarded as more profitable. The amount of commission depends altogether on the size and reputation of the issue, and no definite statement on this point can well be made.

The question frequently comes before such a house, Do you absolutely guarantee the securities that you offer to be safe investments? Invariably the answer is: No, we give you freely the benefit of our experience and of our best judgment, but whatever risk is involved is yours, not ours; we guarantee nothing. Nevertheless,

it is a well-known fact that almost all houses of the best character will protect their customers in case of loss or risk. In the first place, the house does not lose interest in the security as soon as the issue has been sold. It watches the future career of the issuing corporation with the closest attention and frequently exerts strong influence toward a conservative management of the corporation. If in spite of all its care and its efforts, the security depreciates in value, as will happen once in a long time, the house will probably offer to buy it back from its customers at the selling price. This is not laid down as an infallible rule, but as a custom. Of course, the house does not feel bound to follow that course unless it has very strongly recommended the security in the first place. Its motive in making the offer is simply to maintain its hard-won reputation for fair dealing.

CHAPTER XVII

SELLING CANADIAN SECURITIES

142. *Markets for Canadian corporation securities.*—The methods of sale of corporation securities in Canada, in their broad principles, are similar to those in the United States, described in foregoing pages. Generally speaking, Great Britain is relied upon to purchase the majority of these securities, Canada a few, while the United States supplies but little capital. These facts are shown in the following tables. The first shows the volume of bonds, also the share of corporation bonds of Canadian companies, for each of the eight years ended December, 1912:

CANADIAN CORPORATION BOND SALES, 1905-1912

Year	Corporation Bond Sales	Total Bond Sales
1905	$125,497,284	$184,874,581
1906	35,694,000	53,987,008
1907	58,931,200	82,635,740
1908	72,297,000	196,356,521
1909	132,432,500	265,158,252
1910	140,251,900	231,000,590
1911	218,978,700	266,812,988
1912	146,728,320	230,782,982
Total	$925,810,904	$1,461,608,612

The various proportions of the Canadian bond sales, for the same years, taken by the United States, Canada and Great Britain are shown in the following table:

PERCENTAGE SHARES OF CANADIAN BOND SALES, 1905-1912

Year	United States	Canada	Great Britain
1905	6.86	26.06	67.07
1906	7.62	43.16	49.20
1907	5.78	17.86	76.35
1908	3.21	12.52	84.26
1909	3.90	22.50	74.00
1910	1.50	17.00	81.50
1911	6.58	16.86	76.56
1912	11.91	15.96	72.13

143. *Canadian prospectus and British investor.*—In drafting a prospectus for the British market, those responsible for the sale of Canadian corporation securities must always bear in mind the conservative attitude and the demand for full information, of the British investor. The history of the company must be given, and details of past earnings, estimates of future earnings, details of assets, and so on. No tricks should be played in the prospectus. The facts should be given. Otherwise, if trouble should come later, the faith of the investor in the veracity and honesty of the promoters will disappear, which is not helpful, especially if further issues are to be made. It should be remembered that the maintenance of Canadian credit is important to every borrower. Sir Frederick Taylor, manager of the Bank of Montreal in London, expresses this very clearly. Writing in a Canadian financial paper, he says:

It must be obvious to everyone with any knowledge of the subject, or who gives the matter intelligent consideration, that interruption—let alone stoppage—of the flow of capital from England into Canada would instantaneously check the development of the Dominion, with results bordering on the disastrous.

It is not uncommon to hear certain of our countrymen, who should know better, speaking lightly—sometimes almost defiant-

ly—of securing money in New York or Paris if London is not prepared to lend what is required. The answer to these unwise and inexperienced individuals is: "Try Paris, try Wall Street, and see what the result will be."

Money will be forthcoming from the United States and elsewhere in ever-increasing volume for private enterprise in our country, so long as we continue to prosper, but it is to the London market that the Dominion and Provincial Governments, the great transportation companies, the large cities, etc., must come for money. If London discontinued, or even curtailed, the supply of funds to Canada, it would be for some good reason—a reason which would apply equally in the case of other money centres. But as a matter of fact, even to-day when our credit in London is high, it is rubbish to talk of Canada financing her requirements to any material extent in Paris or in New York; while if our credits were injured in London, it would be practically impossible to get money in either of the other two places.

Notwithstanding the fact that the progress and development of the Dominion of Canada have reached a stage which has aroused the wonder of the civilized world, Canadians are united in the belief that the development of their country is still in its initial stage, and therefore this motto should hang upon the walls of every office, business house and financial institution in Canada: The maintenance of our credit in London is vital.

The large difference between the exports and imports of Canada causes that country to send many securities to the London market. If too many securities were offered it would mean that Canada was importing too many goods or exporting too little, or both. Doubtless some Canadian securities have been offered which should not have been issued, and the country's imports have been unwisely increased by the extravagance of a prosperous people, but the main cause each year is the same. As one of the leading financial authorities has said, Can-

ada needs more than ever new mileage of railways, vast quantities of new rolling stock, warehouse and port facilities, municipal expenditures in hundreds of new towns, and an enlarged scale of improvements in all the older municipalities, the building of ordinary roads, bridges, and other conveniences, in many new areas of settlement, the creation of plants for new industries and the general increase of existing plants throughout all Canada, the erection of private dwellings in greater numbers and of more permanent construction than in the past, and many other forms of betterment which need not be detailed.

144. *A typical Canadian prospectus.*—We may examine the typical prospectus of a Canadian corporation issue in London—that of $2,100,000 seven per cent cumulative participating preferred shares of $100 each, of the A. Macdonald Company, Limited. This prospectus gives details of capital, authorized and issued; terms of payment for the stock; history of the company; list of its branches, particulars of assets, earnings, profits; certificates of chartered accountants and appraisal companies; names and occupations of the directors, information as to how the proceeds of the issue will be applied. Indeed, almost all that is necessary for the investor to judge of the value of the offering is given in the prospectus. This is as it should be.

A lengthy letter from the company's general manager, with considerable information, is included. It is written in a conservative tone, as the following extract will show:

> The business of the A. Macdonald Company was founded more than twenty years ago by Mr. Alexander Macdonald, who, prior to that time, had conducted a retail grocery store in the city of Winnipeg. Mr. Macdonald originated the idea of founding a wholesale grocery business on the mail order plan.

Instead of sending travellers on the road to visit the retail trade, he inaugurated the publication of a price list or catalogue, twice a month, which was mailed to all retailers. The company's price lists were accompanied by order forms and envelopes, so that all the retailer had to do was to write his order and mail it to the company.

Gradually, as the business grew, branches were opened at various points, the original warehouse in Winnipeg becoming the head office of the company. As the branches grew in number the demand for the price list also increased, until at the present time there is probably not a retail grocer in the territory covered who does not regularly receive this price list.

Satisfied with moderate profits, and able, through this establishment of branches, to deliver goods promptly, the Macdonald Company has built up an enormous business in Northern Ontario and in the Provinces of Manitoba, Saskatchewan and Alberta. So great has been its success that the entire stock of merchandise has been turned over at the rate of nearly ten times per annum.

145. *Growing United States market for Canadian securities.*—While the bulk of Canadian corporation bonds is sold in Great Britain, there is a growing market for them in the United States. There is no sound reason why there should not be a much wider market for Canadian securities in the United States than there is; for there are few better, and both countries have much in common and clear ideas of each other's opportunities and methods. Already there is a considerable amount of United States capital invested in Canadian enterprises, more than is generally appreciated on either side of the border. But so far, such investments have been largely confined to a few wealthy Americans or to the big industrials, so that the average United States investor has had little interest in the wonderful development of Can-

ada, particularly in comparison with the vast influx of British capital during the last few years.

Financial houses and others, responsible for the sale of Canadian securities, are becoming far more closely associated with United States financial houses. The result is an increasing sale of Canada's securities in the United States.

There is a fairly general disposition in Canada to ignore foolishly speculative and unworthy offerings. The Canadian investor, who is slowly becoming more of a power in his own country, is beginning to eschew worthless mining, oil, land and other stocks with which he is baited. This situation was created probably because of bitter lessons learned in the past, and because so many excellent securities are offered in the legitimate market. As in other countries, the investor in Canada needs a higher rate of interest than three per cent to meet the increased cost of living, which appears in expected and unexpected places. Small bond denominations are popular, and successful efforts have been made by financial houses to appeal to investors with limited savings.

146. *Canada's richest rural community and fox farm finance.*—An interesting development in Canadian corporation financing appeared in Canada in 1912 and 1913—the issue of securities by fox farming companies, chiefly on Prince Edward Island. The review of business conditions during 1912, issued by the Canadian Bank of Commerce, referring to this industry, said:

Prince Edward Island has savings deposits of about $10,-000,000, and is, per capita, probably the richest rural community in the Dominion. To its prosperous industries of agriculture and fishing has been added in late years black fox

ranching, which has reached important proportions and may be said to have outgrown the experimental stage. The present stock of breeding animals, numbering about 400, four-fifths of the total number in captivity in the world, is said to be valued at $2,800,000, and the estimated value of the young foxes this year is $1,800,000. A business which promises such attractive profits may have for a while a disturbing effect upon the regular occupations of the province, but the possibilities of breeding in captivity the more valuable native fur-bearing animals are such as should enlist wide interest and a careful study of the subject.

Here is reproduced the prospectus of the Tuplin Silver Black Fox Corporation, Limited, which offered $200,000 six per cent bonds.

The Tuplin Silver Black Fox Corporation, Limited

WE OFFER

$200,000.00 SIX PER CENT BONDS

(In denominations of $100.00 and $500.00)

at par, with 40 Per Cent Bonus of Common Stock of

The Tuplin Silver Black Fox Corporation, Limited.

(Incorporated under the Nova Scotia Joint Stock Companies' Act.)

CAPITALIZATION

6% Bonds, redeemable at 105%	$300,000.00
Common Stock, par value of shares $10.00 each	300,000.00

PAYMENTS MAY BE MADE IN FULL, OR

25% on Application,	25% on May 15th,
25% on April 1st,	25% on July 1st.

Interest payable semi-annually, October 1st and April 1st. Interim receipts for partial payments will be exchanged for Bonds and Stock Certificates when final payment is made. Subscribers have the right to pay in full at any time. Accrued interest will be charged on all installments unpaid on April 1st.

DIRECTORS

J. H. Winfield, General Manager, Maritime Telegraph & Telephone Company, Halifax .... President

Frank F. Tuplin, Foxbreeder, Summerside, P. E. I., Vice-President

Dr. C. F. Fraser, Director Eastern Trust Co. . Halifax, N. S.

Hon. Senator William Dennis, President Herald Publishing Co .... Halifax, N. S.

W. H. Covert, Director Yarmouth Light and Power Co., Halifax, N. S.

Dr. M. A. Curry, Physician .... Halifax, N. S.

C. L. Grant, Merchant .... Charlottetown, P. E. I.

BANKERS

The Canadian Bank of Commerce .... Halifax, N. S.

SOLICITORS

Covert & Pearson .... Halifax, N. S.

TRUSTEES AND TRANSFER AGENTS

The Maritime Trust Corporation .... Halifax, N. S.

C. L. Grant, Managing Director .... Charlottetown, P. E. I.

F. A. Bowman, Secretary .... Halifax, N. S.

FACTS ABOUT THE INDUSTRY

Purpose of Corporation

The Tuplin Silver Black Fox Corporation, Limited, incorporated under the Nova Scotia Joint Stock Companies' Act, was organized for the purpose of engaging in the raising and selling of the Silver or Black Fox, an industry which has passed the experimental stage and presents the opportunity for profits on a large scale.

The Corporation's assets consist of eleven pairs of Silver Black Foxes, purchased from the famous ranch of Frank F.

Tuplin, at New Annan, on the outskirts of Summerside. This stock consists of nine pairs of proved breeders, which produced and raised thirty-two pups in the year 1912, together with one pair, one and one-half years, old, and one pair raised in 1912. These foxes are the cream of Mr. Tuplin's stock. Mr. Tuplin is known as the largest and most successful breeder of Silver Black Foxes in the world. By process of selection, from year to year, he retained for his own ranch the pick of all the foxes raised, and it is this particular stock which has been purchased by the Corporation.

The Assets

The capitalization of the Corporation consists of $300,000.00 six per cent ten-year bonds, redeemable at 105%, on any interest date, and $300,000.00 of common stock in shares of a par value of $10.00 each. It is estimated that the bonds will be all redeemed within three years, thus returning to the investor his outlay, when the common stock will have the benefit of all the net earnings.

The Capital

The sale of these eleven pairs of foxes to the Corporation carries with it a guarantee of at least twenty-eight young foxes, to be raised during the present year, with a forfeit of $5,000.00 for each young fox short of that number. Thus the Corporation has a *guaranteed* return of twenty-eight young as a profit for the first year. But a conservative estimate of the progeny for 1913 is thirty-five foxes.

Estimated Earnings

The Corporation has given an option for the sale of the twenty-eight young at $4,500.00 each, so that a market for the increase has been secured which will make guaranteed profits for the first year $126,000.00. If the increase amounts to thirty-five, of which there is little doubt, as nine pairs produced thirty-two last year, leaving only three to be produced by the other two pairs, the profits would be $157,500. The net earnings are estimated as below:—

35 young foxes in September, 1913, to be sold at $4,500.00 each	$157,500.00
Less Bond Interest at 6%	18,000.00
	$139,500.00
Dividend of 10% on common stock	30,000.00
Available for sinking fund to redeem bonds	$109,500.00

While options on the get of 1913 are to-day selling for $4,500.00, it is confidently expected that, as in previous years, prices will stiffen to higher figures before delivery date is reached.

Bond Redemption

The mortgage securing the bonds provides that no dividend at the rate of more than 10% per annum shall be paid on the common stock until all the bonds shall have been redeemed, and that no dividend whatever on the common stock shall be paid in any one year unless at least $100,000.00 shall have been paid off in that year.

The Market

The market for the Corporation's output is broad and expanding. Russia is a buyer and a demand for breeding animals comes from many points outside of Prince Edward Island. As to pelts the Silver or Black Fox is the rarest fur-producing animal in the world and its pelt, apart from the value of the animal as a breeder, brings the highest price of any fur. Silver or Black Fox pelts, of good quality, readily bring from $1,000.00 to $3,000.00 each. Undoubtedly the ultimate value of the Silver Black Fox industry must be the market value of pelts, but there can be no doubt that for many years the demand for live stock from various parts of the world, by persons engaging in this business, will be such that the prices for live animals will much exceed the pelt value. It is believed that the present or higher prices will obtain for seven or eight years at least. The sale of six pairs of this year's pups to a Russian company at $100,000.00, or $16,000 a pair, is a proper

basis of calculation of live stock value of the season's litter. The price on which this Corporation bases its estimates is only $9,000 per pair.

Management

The contract with Frank F. Tuplin, from whom the foxes were purchased, provides that he shall care for them, raise the young, and attend to the animals on his own ranch at New Annan, near Summerside, until September, 1913, and the Corporation has his guarantee to pay $5,000.00 for every fox less than twenty-eight that may be produced. After that date the Corporation may build a ranch, or make a new contract with Mr. Tuplin, who has taken a substantial interest in this Corporation. The Tuplin ranch, where the Corporation's foxes are being cared for, and where the young will be raised, is the best equipped in Prince Edward Island. It is located on the outskirts of Summerside, admirably situated in the bush, with plenty of trees for shade for the animals, and is equipped with a first-class water system, with hydrants for fire protection, washing pens, and general sanitary requirements.

Breeding Stock for next year

The Directors decided that it was in the best interests of the Corporation to sell options on the guarantee of twenty-eight at the prevailing figure today, reserving any extra pups for sale on or about delivery date at the then prevailing figures. It may, however, be decided to be in the interests of the shareholders to retain some of the additional increase in order to produce higher returns next year.

Legality of Organization

The Corporation's Solicitors report that the corporation has been duly and properly incorporated and organized, the bonds secured by a mortgage or deed of trust to the Maritime Trust Corporation as Trustee, and the shares issued as fully paid and non-assessable shares, under a certain contract made with Chester McLure, dated the ——th day of ————, ——.

A number of Canadians are said to have written to the Department of Commerce at Washington seeking to buy some of the blue and silver foxes from the government's preserves in Alaska, but no citizen of the United States had made similar request up to July, 1913, although the Department is understood to be anxious to get citizens of the United States to go in for fox breeding.

It is not necessary to discuss the matter here, further than to say that there are undoubtedly large profits in the industry which will probably result in the formation of numerous companies. The consequent issue of stocks and bonds, in turn, will create a situation of interest, not without danger, to the investor.

CHAPTER XVIII

SELLING SECURITIES—THE WALL STREET MARKET

147. *The principal stock exchanges of the United States.*—The stock exchange offers the best market for a great many corporate securities. Some readers are perhaps already familiar with the organization of that market and its manner of conducting business and will find much of the information given in this chapter already familiar. In spite of the importance of the Wall Street stock exchange, however, and in spite of the glib manner in which almost every one talks about it and against it, surprisingly few people have a correct understanding of its operations.

What is said about the New York Stock Exchange and Wall Street in this chapter applies in general, with slight modifications, to a considerable number of smaller stock exchanges in the larger cities of the United States. Chief among these exchanges are:

(1) The Boston Stock Exchange, on which local securities are bought and sold and which is the chief market for the stocks of copper-mining companies.

(2) The Philadelphia Stock Exchange, on which local securities and the securities of the Lehigh Valley, the Pennsylvania and the Reading Railroads are bought and sold.

(3) The Pittsburg Stock Exchange, the principal business of which is the handling of securities of the local steel companies, and of the United States Steel Corporation.

(4) There are stock exchanges also in Baltimore, St. Louis, Chicago and San Francisco, all of which are comparatively small and the operations of which are confined to local securities.

(5) In this group should be included the Consolidated Stock Exchange of New York, or the "Little Exchange," as it is frequently termed, whose members buy and sell the same stocks that are traded in on the New York Stock Exchange, or "Big Exchange." The transactions on the Consolidated are on a much smaller scale than on the "Big Exchange"; stocks are customarily bought and sold in ten share lots or multiples of ten, instead of in one hundred share lots or multiples of one hundred, as on the New York Stock Exchange.

The reader will see from this brief summary that large dealings in securities of corporations of national importance are confined almost wholly to the floor of the New York Stock Exchange. With some exceptions the stock of any corporation will be bought and sold on one exchange and one only; the chief exceptions, to most of which allusion has already been made, are: Amalgamated Copper Company stock, which is handled both in New York and in Boston; Pennsylvania Railroad Company, Lehigh Valley Railroad Company, and Reading Railroad Company, both in New York and in Philadelphia; United States Steel securities, in New York, Boston, Chicago and Pittsburg.

148. *Listing securities.*—In the first paragraph it was stated that the stock exchanges offer an excellent market for the sale of securities of certain corporations only. This limitation must be stated, because each of the exchanges confines its members, so far as trades on the floor are concerned, to a comparatively small number of approved securities. On the New York Stock Ex-

change all new securities offered for approval are investigated before being "listed." The Exchange has strict rules governing the admission of securities to the "listed" class. There is a committee of five to whom are referred all applications for including securities among those listed. Accompanying the application, there must be filed a complete description of the property of the corporation, a full and true balance sheet, an income account, and information on certain other points. In the case of bonds a full statement of the terms under which the bonds are issued, a certified copy of the mortgage, and proof that the mortgage has been properly recorded, must be submitted. The exchange strongly recommends—a recommendation that has all the force of an order—that corporations whose securities are listed shall furnish to their stockholders complete annual reports at least fifteen days prior to annual meetings.

Many industrial corporations which are unwilling to comply with the requirements as to publicity, were formerly admitted to the "unlisted" class. This means that their securities were bought and sold on the floor of the exchange in the same manner as the listed securities, and so far as the general public was concerned there was no apparent difference between the two classes. There was, in fact, however, a very important difference, for the corporations whose securities were unlisted were not required to give complete reports as to their operations to the stock exchange committee or to their stockholders. Although the public did not appreciate the fact that such a distinction existed, men in the financial district were fully alive to its importance. Listed securities almost without exception were much more

highly regarded by bankers and were more acceptable as collateral for bank loans.

For this reason, most corporations preferred to meet all the requirements and have their securities listed. About 85 per cent of the securities handled on the New York Exchange entered the listed department, and the unlisted group—partly on account of the force of the growing demand for publicity—rapidly declined in numbers and in importance. Among the last converts from the unlisted to the listed class were two industrial companies of great size and importance, the American Sugar Refining Company and the American Smelting and Refining Company. This entrance into the listed department was rightly interpreted as a final proof that the day of corporate secrecy, so far as stockholders are concerned, had gone by, and shortly thereafter the useless "unlisted" class was abandoned.

149. *The Curb Market.*—There are a considerable number of large corporations that are unwilling or unable to furnish even the very moderate amount of information that is necessary in order to have their securities entered on the Stock Exchange list. There are other securities that are very highly speculative in their nature, or that are issued by corporations which are not honestly and efficiently managed—"cats and dogs" such securities are called in Wall Street slang—which are bought and sold in considerable quantities in the Wall Street district. As such securities would not be admissible under the rules of any reputable exchange, an outside unorganized market has come into existence. This is known as the Curb Market, for the reason that the meetings of the brokers who participate in it are held in the open air in one of the streets in the Wall Street district near the street curb. There are no written rules

and no fixed organization for the Curb Market. Anyone may go among the throng of brokers standing on the street and buy or sell securities if he can find anyone else to trade with him. As a matter of fact, however, a stranger would not be able to transact any business, for no one would be sure that he would live up to whatever obligations he might contract. In practice, in order to do business on the "Curb," a broker must either have high standing and reputation on his own account or must be a representative of an established brokerage firm. Among the well-known and important corporations whose securities are bought and sold in the Curb Market we may mention the former subsidiaries of the Standard Oil and American Tobacco companies and a number of industrials, the stocks of which are also traded in on local exchanges outside New York, such as the Baldwin Locomotive Company, the J. I. Case Company, Cluett-Peabody Company, Goodrich Company and Studebaker Company. Most of the other active stocks on the Curb Market are of mining companies. The Curb Market is also the center of transactions in "rights" (which are described in Chapter XXIV) and in contracts for purchase and delivery of stock and bonds that are not yet issued. Such stocks and bonds are traded in "w. i.," to use the Wall Street abbreviation, which stands for "when issued."

150. *Stock Exchange methods.*—The scene on the floor of any of the regular stock exchanges and on the street where the curb brokers congregate always seems to an uninitiated observer strange and confusing. On the larger exchanges he sees a number of posts set up at regular intervals, each post bearing the initials of several of the corporations whose securities are listed on that particular exchange. Around each post, if it is a

busy day, are a large number of brokers, each armed with a pencil and a memorandum pad, and many of them engaged in making frantic signs to other brokers. The signs, which are unintelligible to the outsider, indicate offers to buy at a certain price or acceptances.

A broker who has the stock or bonds of any corporation to sell goes to the post to which that corporation is assigned, offers his stock and receives bids. Any reader who has never visited an exchange must not get the idea that this proceeding is as simple and unexciting as it seems when described in cold print. If the market is at all active, the seller may have to fight his way to the center of a struggling group, yell out his offer at the top of his voice, and accept one or more of the bids that may be yelled back at him in the twinkling of an eye. The noise that comes from the floor of a crowded stock exchange during an active business day resembles nothing so much as the roaring of wild beasts.

It has often been remarked, as an indication of the good faith and high standards of honor that must prevail as a rule among stock-exchange brokers, that in the midst of all this confusion and outcry a hasty sign from the purchaser and a nod from the seller of a block of securities may close a deal involving thousands of dollars. Each broker makes his own memorandum of the transaction and at the close of the day the houses which they represent compare notes and through the stock exchange clearing house settle their balances. It is very seldom that a serious error or even a misunderstanding occurs. Differences of opinion as to prices and quantities of securities are, of course, inevitable once in a while, but are usually adjusted in the friendliest manner.

The volume of business transacted in this manner on

the leading stock exchanges is enormous. Million share days on the New York Stock Exchange, though somewhat above the average, are not at all uncommon. In other words, $100,000,000 worth of business is transacted. Of course it goes without saying that such quantities of shares are not bought outright, taken out of the market and placed in a vault. On the contrary, the great mass of the business of buying and selling is speculative. What is actually bought and sold is the right to receive or the right to deliver certain quantities of shares at the end of the day at the price fixed in the deals between brokers. In most cases no actual delivery is made. Through the stock exchange clearing house the transactions in the same stock offset each other and only the balances are delivered by those who sold to those who buy. Many floor traders seldom see any stock certificates because they make it a rule to sell during the day as much as they buy. They make both sales and purchases with the view to "scalping" small profits, 1/8 and 1/4 per cents.

151. *Importance of speculative dealings.*—Nothing need be said here as to the ethics of speculation, a subject which is adequately treated in another volume. It may be well to remark, however, that all these speculative transactions on the stock exchange, particularly the small transactions, perform at least one very useful service, namely, they tend to steady security prices. Obviously, if a stock starts to move up or down and a group of floor traders are at hand all trying to sell at each slight advance with a view to getting their small speculative profits, the price will probably not soar very rapidly. The same remark in substance will apply to all speculative dealings.

Enough has been said about the stock exchanges and

stock and bond brokers to give some idea perhaps of their methods of operation. It is no part of the business of stockbrokers to buy and sell to any large extent on their own account, although many of them, to be sure, do not by any means abstain from so doing. Their main function, however, is to serve as agents for other persons who may desire to buy or sell securities. Some of these persons are true investors who are either parting with some of their stockholdings for cash or are buying securities outright with a view to holding them for the sake of dividends and of future increases in their value. Such persons, however, are in the minority; most of the buying and selling of stocks on the stock exchanges is speculative. Of this speculative business a small proportion is carried on by the outright purchase of stocks or bonds, which the purchaser hopes will rise in value within a short time so that he may sell at a substantial profit; or by the outright sale of securities which the seller hopes to be able to buy back within a short time at a substantial reduction. The great mass of speculative business, however, and for that matter of all the business transacted in Wall Street, consists of buying and selling "on margin."

152. *Buying on margin.*—By marginal transactions are meant those in which most of the necessary funds are borrowed and only a small percentage or "margin" is required of the person for whom the securities are bought or sold. The procedure in making a marginal speculative purchase is somewhat as follows: The speculator desires to own, we will say, one hundred shares of a stock which is selling at or near a par of \$100; the least margin that will be accepted by reputable brokers in such a case will be \$10 per share. The speculator, therefore, assuming that he does not already have

an account with his broker, gives him a check for $1,000 and an order to buy the one hundred shares. A representative of the brokerage firm buys the one hundred shares on the floor of the exchange in the manner already described. At the end of the day he must be prepared to pay for the shares, which means an outlay of approximately $10,000 (100 shares at $100 each). In order to raise this amount the broker arranges with his bank to accept the shares, after they are bought, as collateral for a loan, which on standard stocks will be about 80 per cent of the market value, or on this block, $8,000. There still remains a difference of $1,000 which the broker must supply out of his own funds. If the stock shortly after this transaction advances, we will say ten points, the fortunate speculator will perhaps give an order to sell, and the broker will secure approximately $11,000 for the block. With this he repays the bank loan of $8,000, reimburses himself for his loan of $1,000 and after deducting interest on the $9,000 supplied by the bank and by himself and deducting his brokerage charges, he turns the rest over to the speculator. On the other hand, if the stock goes down seven or eight points the speculator is called upon to put up additional margin or, failing that, the broker sells the stock, repays the bank loan, reimburses himself, deducts interest and brokerage charges as before, and returns to the speculator anything that may happen to be left of his $1,000.

153. *Selling short.*—If the speculator chooses to sell on margin, or "sell short" in the Wall Street phrase, he deposits his $1,000 as before and orders the broker to sell. The broker's representative executes the sale on the floor of the exchange and of course is called upon to make delivery at the end of the day. As neither the speculator nor the broker owns the stock that

has been sold, it is necessary for the broker to borrow the stock from some owner. This he does in the "loan corner," as it is called, of the stock exchange, where stocks are loaned to "shorts" on payment of the market price. In form this loan is a sale of stock; it is provided, however, that on return of the stock the amount paid for the stock will be given back. This borrowed stock the broker uses to make delivery of the block that he has sold. If within a short time the stock goes down, the fortunate speculator orders his broker to buy a block at the lower price; the broker uses the block that he buys to repay the lender of the stock with which delivery was originally made. He turns over to the speculator his $1,000 margin plus the difference between the price at which the block of stock was sold and the price at which it was bought and minus brokerage charges. The brokerage house, when it borrowed stock with which to make delivery, paid to the lender the market value of the stock and is allowed interest on this sum; the speculator, therefore, in his "short" operations is relieved of interest charges. On the other hand, if the stock goes up several points in this case, the broker will call for more margin; failing that, he will buy a block of stock with which to repay the stock he has borrowed, will deduct from the speculator's margin the difference between the price at which the stock was sold and the price at which it was bought, together with brokerage charges, and will then return to the speculator anything that may be left of his $1,000.

154. ***Stock exchange houses vs. bucket shops.***—The following quotation from a circular letter issued by a large brokerage house gives an accurate statement of the terms upon which reputable brokers handle marginal transactions:

We execute commission orders for the outright purchase, in any amount, of listed stocks. Our charge is that fixed for all members of the New York Stock Exchange, $\frac{1}{8}$ of 1 per cent of the par value, or $12\frac{1}{2}$ cents a share, except that we make a minimum charge of $1 for any one transaction.

Our requirement for doing business upon margin is 10 per cent upon the par value of the active Stock Exchange issues quoted at 50 or below; 15 per cent for those quoted between 50 and 100; and 20 per cent for those quoted above 100. We reserve the right, when opening a margin account, to refuse to purchase those securities which either have not a ready market or are not available for collateral purposes. Those who desire to sell active stocks short, may do so upon a maintained margin of 15 per cent, in the case of stocks selling at par or below, and upon a margin of 20 per cent in the case of those selling above par, we, of course, to reserve the right to discriminate against any particular securities.

We do not buy or sell less than 100 shares of stock or $10,000 of bonds, upon margin, so that $1,000 is the least amount with which such an account can be opened. Our interest charges depend upon the cost of our own funds and are figured at the end of each month, so we cannot say in advance just what rate will be charged, but we will be glad to take this question up in detail at any time.

In opening margin accounts we require either a bank reference or an introduction from some of our friends.

We never open margin accounts for women or in the name of a woman nor do we open margin accounts for bank officials or bank employees.

Just a word should be said here about bucket shops and swindling brokerage concerns of all kinds. The characteristic of all such concerns is that whatever money is turned over to them for buying and selling stocks never gets out of their own pockets. Whatever may be said as to the ethics of true stock exchange

speculation, and as to its moral and economic effects, it is certainly true that Wall Street ought not to be blamed for the existence of the methods of the bucket shops. Wall Street brokers are, as a rule, entirely honorable in their dealings with customers. They make it their business to execute whatever orders are given to them by their customers under conditions which are fully and clearly set forth. If the customer misunderstands those conditions or misjudges the market, it is his own fault, not the broker's. A legitimate broker will make every effort to guide his customer aright and protect him from loss, for the broker's reputation and success depend directly on the success of his customers. The bucket shop, on the other hand, obviously prospers from the losses of its customers.

155. ***The classes of Wall Street speculators.***—The Wall Street speculative contingent may roughly be divided into three classes: first, Wall Street men, bankers, brokers or corporation officials, who buy and sell securities on a large scale and who make it their business to keep in constant touch with all that goes on in the stock market; second, substantial men of property and business standing whose first interests are not in the Wall Street game, but who take a "flier" once in a while in some security or group of securities of which they have special knowledge; third, the hangers-on, the true lambs, a class made up largely of professional men, broken-down business men and women, who are suffering under the delusion that they can make money in Wall Street without having a special knowledge either of Wall Street methods or of the conditions in some particular line of industry. This third class is by no means so large as the moralists, the muck-rakers and the comic papers represent; yet it is true that its representatives

are only too painfully in evidence. It is true also that the members of this class inevitably lose in the long run, and that too often they are infected with a poison that ruins them both financially and morally. It is more than doubtful, however, if Wall Street ought to be held responsible for the losses of such people. For the most part they are weak and foolish and it may safely be said that if they had not fallen victims to the Wall Street craze they would have found some other means of losing their money.

156. *A summary view of the stock market.*—What precedes is intended to present to the reader a bird's-eye view of the Wall Street market, or the stock exchange market, for securities. To recapitulate: only a comparatively few large corporations have their securities listed on any of the stock exchanges; those corporations whose securities are listed have a well-advertised, continuous and easily accessible market for their securities; this market is utilized both by investors and by speculators, but, so far as stocks are concerned, the speculative element is of chief importance; most of the speculation is carried on by means of marginal purchases and sales; the speculators may be classified under the three heads, Wall Street operators, business men and "lambs." With these leading facts before us, we are now ready to discuss briefly the process of selling a new security through the stock exchange markets.

157. *Stimulating speculative interest.*—If the new security is a small issue put out by one of the less important companies, the process of selling it through a stock exchange will not be much different from that which has been described in previous chapters. The new security will be advertised, inquiries will be invited, an alluring prospectus will be issued, the new security

will be listed and the corporation managers will then sit back and wait for orders to reach them.

Let us suppose, however, that a new stock of a large issue is to be put out by one of the well-known companies. In that case, the corporation managers, or the syndicate which is underwriting and handling the sale of that stock, will not only take all the means mentioned in the preceding paragraph to insure the success of the sale, but will go further. They will take measures to create a speculative interest in the stock and to "make a market" at a good price.

In addition to their advertisements and prospectuses, they will probably set to work other forces still better fitted to secure buying orders from marginal speculators. Now the average speculator is not much attracted by brass band announcements or even by newspaper stories, no matter how well written and convincing they may seem. But he rises to a tip like a hungry fish to the bait. He reasons that what is known to everybody will bring little profit to himself, but that information which comes to him confidentially by word of mouth gives him an exceptional opportunity. Therefore, Wall Street, from morning to night in an active market, hums with tips, rumors and gossip. The tips that are thus circulated are not all valueless by any means, although it must be admitted that a speculator who follows them too closely will probably be a heavy loser in the end. The first move, then, of the managers of a large new stock issue will probably be to see to it that rumors as to the extent and high quality of the issue, and above all, as to the "interests" that will support its market price, begin to circulate. Thus the appetite of speculators will be stimulated and large buying orders from them will prob-

ably await the first appearance of the stock on the market.

The next step will be to range the brokers in favor of the new issue, so that whatever advice they give to their customers will tend to favor its purchase. The most direct method of securing the brokers' favorable attention is by seeing to it that the new stock is acceptable as collateral for bank loans. Partly for this reason it is very important that among the persons interested from the beginning in the new issue should be representatives of large banking interests. If the broker feels sure that the stock will be acceptable as collateral, he knows that he will be able to carry large amounts of it for his customers on easy terms.

158. *Syndicate operations.*—The next step is to secure an agreement among the syndicate members and perhaps w... large banking and brokerage interests outside the syndicate that the price of that particular security will be held at a given figure. Thus when the Interborough-Metropolitan Company, the great $240,000,000 merger of the transportation lines of New York City, was formed, the members of the syndicate were said to have agreed that the price of the common stock should not be allowed to fall below fifty. In order to maintain the price at this point they were compelled after the stock had been issued to purchase large blocks and take them off the market. In this particular case the syndicate, for reasons which need not be here discussed, went to pieces after about a year, and the price of the common stock suddenly broke very sharply. During the year, however, the agreement was lived up to. Where such an agreement is made and maintained the effect is to steady the price of the stock, or at least

to hold it above the figure agreed upon, and thereby to attract both speculators and investors.

159. *Stock market manipulation.*—The fourth step in making a market for a new issue is to manipulate the price in such a manner as to gain the good will of speculators and brokers and arouse expectations of large profits. Manipulating a stock is a process that requires great skill, judgment and cool nerve. Several men in the Wall Street district have become famous for their abilities along this line; foremost among them is the well-known and successful operator, the late James R. Keene. To Mr. Keene was entrusted most of the large speculative stock flotations of recent years. He was almost uniformly successful.

One method by which a manipulator may fix a quotation for his security is by "wash sales," by which is meant selling with one hand and buying with the other. Brokers on the New York Stock Exchange, according to the rules of the exchange, are not allowed to be parties knowingly to such a process. They are not supposed to know, however, and as a matter of fact, cannot know, whether or not a selling order given to them is matched by a buying order simultaneously given to another broker. By means of such matched orders a manipulator may raise or depress the price of a stock almost at will with no further expense than brokerage commissions—provided, of course, that his plans are not interfered with by large buying or selling orders from other parties. It is customary for a stock market manipulator in this manner to fix or attempt to fix the price of a security at the beginning and then gradually raise its price and thus stimulate speculative interest in the security.

As the security advances in price and stockholders

begin to send in their orders to buy, the manipulator, if his plans work out successfully, gradually feeds out small amounts of the stock that he has on hand. This process must be very gradual and carried on in such a manner that it cannot easily be observed; otherwise, the stock-market price will be depressed, stockholders will take warning and will begin to sell and the market will be spoiled. Furthermore, it is not well to allow the price to go up too rapidly or too steadily; otherwise the manipulation will be too apparent and furthermore no opportunity will be given to prospective buyers to purchase at slight recessions from previous prices. The price of a skillfully manipulated stock will move upward and downward by jerks, the tendency on the whole being upward. If the manipulation is secret and skillful, not even the most expert observer can be certain whether the price is subject to manipulation or not.

It will be impossible here to enter into a study of all the intricacies of manipulation and of the schemes which have been successfully worked in the past. The object of this chapter is attained if the reader sees that the securities, stocks especially, of large corporations may be sold through the stock market at much higher prices than would be possible if the same stocks were sold direct to investors. A further study of this interesting branch of our subject will be found in the volume on INVESTMENT AND SPECULATION.

CHAPTER XIX

SELLING SECURITIES—THE UNDERWRITING SYNDICATE

160. *Origin of underwriting.*—One means of floating an issue of securities, we have seen, is to dispose of them through the agency of banking and brokerage houses. In such cases the financial houses may not merely undertake to sell the securities, but may make themselves responsible for the success of the sale. One method of so doing is by agreeing to take for themselves, if no other purchasers are found within a specified period, all of the unsold portion of the issue at a certain agreed price. Thus the issuing corporation is relieved of part of its risk and the buyers of the securities are made to feel that well-informed financiers have faith in their value. This process—modified more or less, as described later in this chapter—is known as underwriting.

The origin of underwriting is to be found in the famous London institution called Lloyd's. Lloyd's Coffee House was the place where the export and import merchants of London assembled in the 17th century to transact their business with shippers. As all such trade at that time was peculiarly subject to mishaps of all kinds, the practice grew up of dividing the risk on cargoes and shipments among a large number of merchants; each party to the agreement wrote his name under the contract and from this custom arose the name "underwriting." We are to discuss in this chapter the

same principle as it is now applied to new issues of securities. The essential part of the arrangement is the insuring of someone against loss or failure. A secondary feature is the division of the risk among a considerable number of people, so that no one of the insurers is liable to suffer great loss.

161. *Advantages of underwriting to the corporation.* —There are several reasons why banking and brokerage houses may properly carry on this business of financial underwriting and why the business is usually profitable both to themselves and to the corporation which issues the underwritten securities. In the first place, the bankers are presumably experts in the valuation of securities. Their judgment as to the price which should be set on a new security or as to the terms of exchange, if the new security results from a conversion of an old security, is a valuable, authoritative judgment. In the second place, the bankers are also experts in selling securities and each house involved in the underwriting usually has an established clientele to whom it may readily dispose of almost any securities that it recommends. The corporation, on the other hand, has no facilities whatever for selling stocks and bonds; its activities are in the field of transportation, or industry, or trade, not in finance.

Two further reasons are even more potent in inducing corporation managers to have new security issues underwritten. First, even though the corporation can obtain expert financial advice and is reasonably sure to make a success ultimately of the sale of any securities it puts out, yet the time that will elapse before the sale is completed and the money received is always uncertain. Now the corporation ordinarily would not be trying to sell new securities if it did not need money at once or in

the near future. It is disastrous to the success of many industrial or commercial operations to hold them in abeyance until the tedious process of selling a large block of bonds or stocks is completed; yet it is dangerous to go ahead so long as the sale is incomplete. This delay can be avoided by having the security underwritten, for the underwriters will pay the corporation within a definite period. The second reason that appeals strongly to corporation managers is that the credit of a corporation is seriously affected by any apparent inability to market its securities. One failure—or even a success that is too hard-won—would hamper the corporation greatly both in getting loans and in making future sales of stock.

162. *Advantage to the buyers of securities.*—There are telling advantages to the buyers of securities also in having them underwritten. As was pointed out in Chapter XVI, reputable banking houses never sell securities until after they have been satisfied by a searching investigation that the securities are all that they are represented to be. Though this does not mean a guarantee on the part of the banking house, it does mean that the buyer has the advantage of their expert, and presumably impartial, examination of every question, legal, financial, accounting, engineering or commercial, that pertains to the new security. This investigation is expensive; no ordinary investor could afford it on his own account. He is, therefore, willing to pay a little higher price for a security if this service has been performed.

Another advantage to the buyer is that he may be sure that the whole security issue has been sold by the corporation. A half-sold issue is a sign of weakness and a hindrance to the completion of the corporation's plans

so serious as to reduce the value usually of the portion that has been sold. Suppose, for instance, that an industrial company desires to build a new plant at a cost of $10,000,000 and sells only $8,000,000 worth of the securities which are intended to finance the project. What can the company do? It can neither complete the plant nor return the $8,000,000. In all probability the money will be used unprofitably and the stocks or bonds sold by the company will be poorly secured. This danger is avoided when the whole block of securities is taken at one time by underwriters.

A third advantage to the buyer is that any reputable banking house will watch closely any security that it has underwritten, and will come to the assistance of the security-holders in case the corporation later gets into difficulties. As will be brought out in our study of reorganization, the committees formed to assist in devising plans to reorganize insolvent corporations almost always contain representatives of banking houses who are there to look after the interests of their clients.

For these reasons underwriting certainly adds to the value of securities. The underwriters naturally are not impelled by charitable motives; they expect a reasonable compensation for their risk and trouble, and frequently the compensation runs well up into millions of dollars. Barring collusion and graft, which have been only too apparent in isolated cases, it may be laid down as a general rule, however, that the underwriters give more than value received. There is no question in the writer's mind but that our corporation financing is cleaner and more efficient because underwriting is the general practice. It is hard to over-estimate the value of examination and supervision by fair-minded financial experts.

163. *When is underwriting advisable?*—It must not

be inferred that every new stock or bond issue ought to be underwritten. Small issues, say $500,000 or less, can usually be sold to a comparatively small number of investors by direct solicitation on the part of the corporation. Then again, well-established, successful corporations frequently sell new stock or bond issues to their stockholders at bargain prices. Ordinarily there is no risk in such a sale and consequently no necessity for underwriting.

An interesting concrete case, in which there is doubt as to whether new issues of bonds should be underwritten or not, was brought to public attention in March, 1909. At the annual meeting of the stockholders of the Pennsylvania Railroad Company Mr. Moorfield Storey, a Boston lawyer, submitted the following resolution:

Whereas, the Pennsylvania Railroad Company is to-day the first railroad corporation in the world, and its securities are entitled to rank with the best that can be offered, and, therefore, to command the highest price in the markets, both of this and foreign countries; and,

Whereas, There is now abundant capital in the hands of capitalists and combinations of capitalists the world over, who are seeking opportunities for buying such securities, and it is desirable that the directors of this company should take advantage of the opportunity which these conditions afford to obtain the highest price possible for such securities as the company now proposes to sell; and,

Whereas, The sale of railroad securities to the highest bidder after open competition will do much to remove the public belief that such securities are issued for excessive amounts, and thus tend to prevent legislation adverse to these corporations, which is now threatened.

Resolved, That the stockholders of the Pennsylvania Railroad Company desire to have the proposed issue of securities so offered as to be open to competitive bidding by responsible

banking houses, and that the issue of securities should be advertised in advance, it being required that such bids shall be accompanied by certified check for such amount as may be necessary to insure good faith.

This reasoning sounds plausible at the first hearing, but is far from convincing. It fails to take unto account the risks involved in the proposed plan and the advantage to the railroad of having the right kind of banking connections in periods of financial stress. In the course of an able discussion of this proposal the *New York Evening Post* said:

Those who hold different views appeal to the Pennsylvania's own experience in 1903. Early in that year, when the stock was selling around 157, the shareholders were offered \$75,000,000 new stock at 120. Before the time for closing the subscription list expired, the price of the old stock had fallen almost to 120, and the management was confronted with the difficulty that beset the Steel Corporation the same year, when bonds which had been offered to the shareholders at par were selling in the open market at 65. Needless to say, the Steel bonds were finally sold to a syndicate and not to the shareholders. When Pennsylvania dropped to around 120, in the spring of 1903, a banking syndicate was hastily formed to underwrite the new issue for which a commission of 2½ per cent was allowed. Before the whole operation was concluded the old stock had touched 110¾. Under favorable conditions a road in such high credit as the Pennsylvania, the St. Paul, the Great Northern, the Union Pacific, the Illinois Central, or the Northwestern could get a better price for an issue of bonds by shopping among the international banking houses than by confining negotiations to one banking firm. But all of the roads named have at one time or another been forced to borrow when the prices of investment securities were falling or when money market conditions were unfavorable.

A railroad which has established permanent banking connec-

tions has a guarantee that money can be raised in troublesome times, when necessary, as well as when investors are clamoring for securities. When acting in such capacity bankers are supposed to advise a railroad what kind of securities will find the readiest market exactly when the securities should be issued, a very important point, and what price the public should be asked to pay for the issue. It is also the business of railway bankers to protect the market for a new issue until the securities reach the hands of investors.

164. *Why underwriting syndicates are formed.*—It would naturally be expected that each of the large financial houses engaged in the underwriting business would handle on its own responsibility whatever business comes its way, and that rivalry would prevent their co-operating to any considerable extent. The fact is, however, that these houses have long since learned that it is inadvisable for any of them, no matter how powerful to guarantee the success of a large security issue. It is true that the banker's judgment and experience should enable him to avoid heavy risks; yet a certain amount of risk is inevitable. A banker does not know what may happen in the financial world, does not know when the bankruptcy of some big concern or unexpected political events may create a sudden panic. If he is caught at such a time with his funds tied up in a large issue of new and unsalable securities, he may be forced into bankruptcy and is almost certain to suffer severe loss. It is not considered conservative banking, therefore, for any one house or even any two or three houses to underwrite a large issue. Many banking houses follow a definite policy in this respect and refuse absolutely to underwrite more than a certain sum, say \$100,000 or \$500,000 or \$1,000,000, depending on the size of the house, even when the risk seems particularly small.

Another reason for co-operation among bankers is that each house desires to offer a variety of securities to its clientele. If it specializes too much or offers only a few securities, it cannot expect to attract and hold regular customers.

A third reason for co-operation is in order that a broad geographical distribution may be obtained and the sale of the security issue be made correspondingly easy. A Pittsburg steel company, we will say, is putting out a large new bond issue and gets a New York banking house to underwrite the issue. New York and Pittsburg investors may be loaded with similar bonds already; under such circumstances the New York banking house will certainly invite houses in Boston and Chicago and other centers, which are not yet saturated with such bonds, to participate in the underwriting.

For these reasons the banks and brokerage houses that handle this business on a large scale always band themselves together in the case of an issue of considerable size into an underwriting syndicate. By means of the syndicate the risk, the trouble and the profits are divided among several houses. The syndicate so formed may belong to any one of five types.

165. *Five types of syndicates.*—Originally the normal arrangement was to have the syndicate as a whole guarantee the price of the issue, and let the corporation attend to the selling. Under this plan, to give an example, a corporation putting out a $5,000,000 bond issue would offer the bonds to the public at a fixed price, say 95, and the syndicate would agree to accept any of the bonds not bought by the public at a lower price, say 90. This is underwriting in the original sense of the word; it is a species of insurance. Under such a plan the syndicate would have two sources of profit; first, a

commission on the portion sold to the public, or a fixed bonus; and, second, the difference between the wholesale price to them and the retail price at which they would ultimately dispose of the bonds. The ordinary commission would range between 2 and 5 per cent. This type is seldom used nowadays, principally for the reason already given that the corporation is not well equipped to attend to the sale of securities.

A second type, also rather unusual, is a syndicate formed to take an "underwriter's option." Under this plan the syndicate takes the block of bonds or stock at a fixed price, payable only as resold. As fast as the syndicate disposes of the bonds it turns over the proceeds to the corporation, after deducting whatever it receives above the fixed price. The corporation pays somewhat less for this service than for other kinds of underwriting, because the syndicate takes no risk; on the other hand, as the corporation cannot be certain when it will get its money, the type is not much favored by conservative corporation managers.

The third type of syndicate comes into existence when a large banking house has bought for itself a big security issue and wishes to distribute the risk. In such a case the original underwriter frequently calls upon other banking houses and upon individuals to take portions of the issue at prices low enough to be attractive. The agreement with the parties who are called in may be executed in anticipation of a contract that is about to be made between the original underwriter and the corporation. Full details as to an excellent example of this type of underwriting syndicate will be found in the agreement made in order to guarantee the conversion of the United States Steel Corporation preferred stock, which is given in full on pages 270-277.

166. *A fourth type—pooling the sale of the security.* —The fourth type of syndicate acts as a unit in making a contract for the purchase of an issue and pools the sale of the stock or bonds. The chief difference between the third and fourth types lies simply in the fact that the syndicate members deal directly with the corporation, not with a banking house. They thus secure for themselves all the profits of the underwriters. Such a syndicate is always managed by some one house or individual having complete authority. Its organization and management are further discussed below. On the whole, this is probably the best known and most common form of large syndicates.

To illustrate the workings of this type we will suppose that a syndicate has been formed, under the leadership of Speyer & Company, to underwrite a $25,000,000 bond issue at 90; to the public the price of the issue, we will say, is 95. One concern may agree to take $1,000,000, or one-twenty-fifth of whatever amount the public fails to buy; another concern may take $2,500,000, or one-tenth of whatever is left unsold, and so on. All the bonds are left, in this form of syndicate, with Speyer & Company, who offer the bonds to the public and sell all that they can. If the whole issue is taken by the public, each party to the syndicate receives his profits, after deducting expenses, without further trouble. If the public does not take the whole issue, each member must take his agreed proportion at the syndicate price, 90. In good times the risk in such a transaction is slight; if the public is indisposed to buy bonds, however, or if any serious mistake in their valuation has been made, the syndicate members may lose heavily.

167. *A fifth type—distributing the security.*—The pooling arrangement above described, although it se-

cures centralized and efficient management, is apt to prove unsatisfactory in that it does not bring into play the whole selling machinery of the various syndicate members. For this reason it has become more and more customary of late years to distribute the security issue among the members of the syndicate. This is the fifth type of an underwriting syndicate. Strictly speaking, of course, the distribution of securities is not an underwriting in any sense, but a sale. It is a sale at a special price, however, made under certain restrictions and designed to serve exactly the same purpose as true underwriting; the term therefore is freely applied to it in the Street. Chief among the restrictions on the sale is an agreement, either tacit or written, that the securities shall not be resold to the public at less than a certain fixed price. Frequently it is also agreed that some one or two of the syndicate members shall be given the first opportunity to advertise a sale of the securities, and that the other members are to keep out of the open market for a limited period. Such an agreement would not bar any of the syndicate members from selling the securities to their regular clients.

Among the members of a syndicate of this type there are frequently several individuals and institutions who are buying the securities, not for resale, but for investment; they are simply getting on the ground floor, making their investment at the special syndicate price. Readers will perhaps recall that this practice was brought to public attention and much discussed during the great insurance investigation of 1904. Mr. George W. Perkins, later of the firm of J. P. Morgan and Company, and Mr. James H. Hyde, among others, alleged that their participation as individuals in syndicates, which was disclosed during the investigation, was for the

purpose of buying bonds at especially low prices for the insurance companies which they represented. One objection to allowing investors to participate in syndicates of this type is that they may decide later to sell the securities allotted to them before the banking members of the syndicate are through selling, and may thereby break the price. With the view to avoiding such a result syndicate managers are exceedingly careful in choosing members who buy for investment, not for resale.

168. *The large underwriting houses*.—The *Wall Street Journal,* in a recent article dealing with the practice of the big corporations in disposing of bond issues to underwriting syndicates of the third, fourth and fifth types, says:

> One method is to sell the bonds in a block to one of the great underwriters. Pennsylvania, Baltimore and Ohio, Union Pacific, and many others, sell direct to Kuhn, Loeb & Company, get the money, and thereafter take only an indirect interest in the bonds. Rock Island sells to Speyer & Company, 'Frisco to Blair & Company and others, New York Central, Lake Shore, Southern Railway, Erie and others to J. P. Morgan & Company. The price at which these railroads sell their bonds to the underwriters is not generally known. It is taken to be a private matter, but it often leaks out.
>
> Another method, not uncommon, is to sell the bonds to the big retail bond houses who distribute them to a wide and wealthy public through advertising and through correspondence. Each of these houses has its clientele. Some are strong in New York, others in Canada, others in the South, etc. They are more or less specialists, and get to be known for a particular grade of bonds or stocks.
>
> These two methods, of course, overlap greatly. Harvey Fisk & Sons, for instance, known for years as a big retail bond house of wide clientele, frequently underwrite whole issues of securi-

ties, as in the case of the Electrical Securities collaterals, recently brought out. Similarly, Fisk & Robinson took the whole issue of the new Buffalo & Susquehanna Railway 4½s. J. P. Morgan & Company, Kuhn, Loeb & Company and Speyer & Company generally participate to a greater or less extent in any extensive new bond issue, because their clientele demands it, even though these firms may not be the original underwriters.

Summing up what has been said with regard to the various types of underwriting syndicates, it is evident that the tendency is growing for the corporation to sell its new security issues at fixed prices to the large banking houses and then wash its hands of the business of selling the securities. Experience has demonstrated that this is the best method for the corporation. Banking houses also prefer this method to the original underwriting, which consisted simply in guaranteeing the price, for two reasons: first, because they can thus control the price and time of sale and bring to bear their skill in selling; second, because the underwriters, having full control of the securities, can post them as collateral and secure bank loans, thereby reducing their direct cash obligations.

In making this last statement the writer has in mind the distinction between "banking houses" and "banks" which may not be familiar to all readers. "Banking houses," so-called, seldom carry deposits to any great extent from other people, and do not make a business of loaning money. Their chief interests lie in buying and selling securities. "Banks," on the other hand, draw their profits mainly from receiving deposits and making loans.

CHAPTER XX

THE MANAGEMENT OF THE UNDERWRITING SYNDICATE

169. *Informal agreements.*—As there are only a few large banking houses and institutions, even in the whole country, which ordinarily take part in large underwriting syndicates and as these houses are thoroughly familiar with each other's policies and resources, the agreements among them are frequently quite informal. In one large transaction recently, as was later brought out on the witness stand, J. P. Morgan and Company formed an underwriting syndicate simply by allotting a certain proportion of the security issue to each of several large firms and institutions. The members of the syndicate were not consulted at all or even advised in writing, but were merely called on the telephone and notified of their participation. The informality was possible in this case because the syndicate was expected to make good profits and J. P. Morgan and Company well knew that everyone concerned would gladly take as large an allotment as the syndicate managers would grant.

170. *A formal syndicate agreement.*—*Ordinarily,* however, a formal syndicate agreement is drawn up and signed. As these agreements are not generally made public, their exact terms seldom become known. The most elaborate and perhaps the most important agreement of this nature that has been given out, was produced on the witness stand in the famous suit to prevent the conversion of United States Steel preferred stock into bonds, referred to in Chapter XV. The agreement

is of such interest and importance that it is given in full below:

U. S. STEEL CORPORATION PREFERRED STOCK RETIREMENT SYNDICATE AGREEMENT.

An agreement made the 12th day of March, 1902, by and between J. P. Morgan & Co., co-partners, as Bankers, of the City of New York, parties of the first part, and the subscribers hereto (hereinafter called severally, parties of the second part).

Whereas, The United States Steel Corporation (hereinafter called the "Steel Company") proposes to make with J. P. Morgan & Co., a certain contract or contracts whereunder in behalf and on account of the Steel Company they are to offer to all of the preferred stockholders of the Steel Company, severally and ratably, the preferential opportunity of subscribing for and of taking at par the "Ten-Sixty Year" Five Per Cent Sinking Fund Gold Bonds of the Steel Company in even amounts approximately equal to 40 per cent of their several holdings of preferred stock, such subscriptions to be payable in such preferred stock at par, provided that every such subscription stockholder at the time of such original subscription payable in preferred stock shall have the right of his option then to make an additional subscription payable in cash for such bonds to an amount equal to 25 per cent of his stock subscription; such bonds to be authorized now for the principal sum of $250,000,000 and

Whereas, in and by such contracts J. P. Morgan & Co. are to guarantee to the Steel Company, that subscriptions for such bonds will be made for the aggregate sum of at least $100,000,000, payable in preferred stock to the extent of four-fifths of said sum, and in cash for the remaining one-fifth thereof; such contracts to provide for the payment or allowance to J. P. Morgan & Co., of a commission of 4 per cent upon the aggregate par amount of all such bonds, which shall be sold and delivered under their said offer, or to them, they

having the prior right to take all of such bonds which shall be offered for subscription, and which shall not be taken by the preferred stockholders under such offer; and

Whereas, upon the terms of this agreement, and for the purposes above mentioned all of the parties hereto now desire to form a syndicate to provide and to furnish to J. P. Morgan & Co. for delivery to the Steel Company the preferred stock, and the cash required under their said guaranty, and to receive from J. P. Morgan & Co., four-fifths of the net commissions by them received under the said contract or contracts with the Steel Company, which contracts J. P. Morgan & Co. are authorized from time to time to make, modify and perform, as in the exercise of their unlimited discretion from time to time they may deem proper, do agree, as follows, viz.:

First. On signing this agreement each subscriber has delivered to J. P. Morgan & Co. certificates for preferred stock of the Steel Company in the amount indicated in his stock subscription hereto, which preferred stock, to such extent as may be required to meet the requirements of their said guaranty, is to be delivered to the Steel Company at par in exchange for the Ten-Sixty Year Five Per Cent Gold Bonds of the Steel Company for an equal amount at par, to be received therefor by any subscriber, and any such preferred stock not so delivered to the Steel Company is to be returned to the subscribers ratably according to their several subscriptions.

Second. Each subscriber further agrees to pay J. P. Morgan & Co. in cash the sum specified in his cash subscription hereto, for which cash J. P. Morgan & Co. shall receive from the Steel Company bonds as aforesaid at par equal to the amount of such cash payment by such subscribers.

Third. The several deliveries and undertakings of the several subscribers under this agreement shall be made and performed by the subscribers respectively when and as requested by J. P. Morgan & Co. or by the subscribers, of any of said Five Per Cent Sinking Fund Gold Bonds of the Steel Company.

Fourth. The several subscribers shall be called upon to

make payments of cash in respect of their several subscriptions only ratably according to the several amounts thereof; but each subscriber shall be so responsible to the full extent of the several undertakings regardless of performance or non-performance by any other subscriber. In the same proportion except as otherwise provided the several subscribers shall be responsible for loss resulting to the Syndicate under this agreement. Nothing herein contained shall constitute the parties hereto partners, or shall render any of the subscribers liable to contribute more than his several proportionate amount as herein provided.

Fifth. In the case of the failure of any subscriber to perform any of his undertakings hereunder as and when called for by them, J. P. Morgan & Co. in behalf of themselves and the syndicate shall have, and at their sole and exclusive option they may exercise, the right to exclude such subscriber from all interest in the Syndicate, and in their discretion, without any proceedings, either at law or in equity, they may dispose of such subscriber's participation hereunder of any interest or right of such subscriber hereunder or under any of said proposed contracts, but nevertheless, each subscriber in default shall be responsible to J. P. Morgan & Co. for the benefit of themselves and the other subscribers hereto for all damages caused by any failure on his part. At any public sale under this article of any interest or right of any subscriber J. P. Morgan & Co. or any party thereto may become purchaser for their own or for his own benefit, without accountability; but notwithstanding any sale, whether public or private, the defaulting subscriber shall be responsible to J. P. Morgan & Co. and to the Syndicate for all damages caused by such failure on his part.

Sixth. J. P. Morgan & Co. shall have full power in their discretion from time to time, to agree with the Steel Company upon the terms and provisions of any contracts such as are above referred to; and also, from time to time, to enter into any agreements with the Steel Company modifying the said contracts as they may deem expedient. They may deliver to

the Steel Company a copy of this agreement, having annexed thereto a list of the subscribers; and thereupon to the extent of their several subscriptions, the subscribers, severally and respectively, but not jointly, and no one for any other, shall become responsible for the performance of such contracts with the Steel Company in discharge of the obligations thereunder of J. P. Morgan & Co. Any and all contracts with the Steel Company made by J. P. Morgan & Co. shall be open to inspection by any subscriber at the office of J. P. Morgan & Co.

Seventh. J. P. Morgan & Co. shall be the sole and final judges as to whether at any time it is to the interest of the Syndicate to proceed further under this agreement or under said proposed contracts; and wherever they may deem expedient, they may abandon the objects contemplated, in this agreement and said proposed contracts and all further proceedings thereunder. In such event all the cash or stock and bonds by them received and then held for account of the Syndicate, and the proceeds of such stock and bonds shall remain charged with the payment of all expenses and liability by them incurred hereunder and shall be applied:—

First to the payment of any and all expenses and obligations incurred by J. P. Morgan & Co. under any provisions of this agreement.

Secondly, in repayment to the subscribers (so far as the same may be sufficient for that purpose) of all amounts of preferred stock or of cash by them respectively delivered hereunder to J. P. Morgan & Co., such repayment to be made to the subscribers ratably.

Eighth. J. P. Morgan & Co. shall be sole managers of the Syndicate, and in behalf of the Syndicate they may make any and all arrangements, and may perform any and all acts, even though not herein provided for, in their opinion necessary or expedient to carry out the purposes of this agreement, or to promote or to protect what they deem to be the best interests of the Syndicate.

The enumeration of specific powers in this or in any other article of this agreement shall not be construed as in any way

abridging the general powers of this article intended to be conferred upon or reserved to J. P. Morgan & Co.

NINTH. From time to time before October 1, 1903, J. P. Morgan & Co. in behalf of the Syndicate, may make sales of all or any part of the bonds received by them for account of the Syndicate. Any such sales may be made by J. P. Morgan & Co. either publicly or privately, by themselves, or in such manner as they may deem proper, and shall be upon such terms and for such price or prices as they may deem expedient. Each subscriber hereby assents to, and agrees to be bound by any such action.

No subscriber shall be entitled to receive any of said bonds before October 1, 1903. In the meantime, in their discretion, J. P. Morgan & Co. either themselves may retain all or any part of such bonds, or they may deliver to any subscriber his proportionate part thereof, upon his agreement to hold the same subject to sale by J. P. Morgan & Co. and to return the same upon call of J. P. Morgan & Co. at any time before October 1, 1903.

Should any subscriber desire to withdraw from sale the portion of bonds to which he may be entitled hereunder, J. P. Morgan & Co., in their discretion may deliver to any subscriber his portion of such bonds upon his agreement to hold the same for himself without sale until October 1, 1903, or until the complete sale by J. P. Morgan & Co. at an earlier date of all bonds held by or for the Syndicate.

TENTH. Until October 1, 1903, or until the final distribution hereunder, J. P. Morgan & Co. in such manner, at such prices, on such terms, and in such amounts as they may deem expedient, shall have power for account of the Syndicate, to make purchases of the 5 per cent gold bonds and of the preferred stock of the Steel Company, and they may resell any such bonds and stocks which they may have purchased and in their discretion they may make any further undertakings of any kind with any persons concerning any such bonds and stocks. They may apply towards any such purchasers any

sums realized from any sales of bonds and stocks of the Steel Company under any provisions of this agreement; and they may make advances, or may procure loans, and may secure the same to such amounts and in such manner as from time to time they may deem expedient for any of the purposes of this agreement.

Eleventh. J. P. Morgan & Co. shall issue to the subscribers suitable receipts in respect of payments made hereunder, and they may issue to the respective subscribers certificates of interest of such tenor and form as they may deem suitable. Such certificates of interest and rights and obligations hereunder of the respective subscribers may be made transferable in such manner and on such terms and conditions as J. P. Morgan & Co. may prescribe.

Twelfth. J. P. Morgan & Co. shall have authority from time to time and at any time to incur such expenses as they may deem proper in carrying out, or endeavoring to carry out, this agreement or said proposed contracts, or in doing any act or thing which they may deem to be in the interest of the Syndicate, and all such expenses shall constitute and be a prior charge in their favor upon any and all moneys, stocks and bonds by them received hereunder shall hold by them as bankers in general account. They also shall have power and authority, in their sole and absolute direction, finally to fix and pay all compensations or depositaries, brokers, agents and counsel, or others, and in the expense account may be included brokers' commissions as usually paid.

Thirteenth. After the complete performance of the entire obligation of the Syndicate hereunder, but not before the first day of October, 1903, unless otherwise determined by J. P. Morgan & Co., in the exercise of their unrestricted discretion, payment may be made to the Syndicate by J. P. Morgan & Co. for the purpose of this agreement, out of any moneys for such purposes received or retained by J. P. Morgan & Co.

Fourteenth. J. P. Morgan & Co. shall not be liable under any of the provisions of this agreement nor for any matter

therewith connected except for good faith in performing or in refraining from performing or carrying out, the obligations by them herein expressly assumed; the implication of any obligation not herein expressly assumed by them being hereby expressly denied and waived.

It is understood that, in the same manner as other subscribers, J. P. Morgan & Co. may become subscribers hereto, that as such subscribers they shall be liable for all subscriptions by them made, and that in all respects they shall be entitled to the same rights and benefits as any other subscriber. Any subscriber hereto may, on his own account, make any agreement with any other subscriber or with the Steel Company.

Fifteenth. This agreement shall bind, and is for the benefit of the parties hereto and their administrators and executors, severally and respectively, but no assignment hereunder shall be valid unless assented to in writing by J. P. Morgan & Co.

All rights and powers J. P. Morgan & Co. hereunder shall vest in said co-partnership firm, as from time to time constituted, without further act or assignment.

Sixteenth. Nothing herein contained shall be construed as creating any trust or obligation whatsoever in favor of any person or corporation other than the subscribers, nor any obligation in favor of the subscribers excepting only as herein is expressly provided.

Seventeenth. Each subscriber shall set opposite his subscription hereunder an address, to which notices, calls or other communications may be sent, and any notice, call or other communication addressed to any subscriber at the address so given, and either at such address or mailed, shall be deemed actually given to such subscriber, and shall be sufficient for all the purposes hereof. If any subscriber shall fail so to furnish an address to J. P. Morgan & Co., he shall not be entitled to any notice of calls or offers, or any other notice hereunder, and he shall be deemed to assent to any action of J. P. Morgan & Co.

Eighteenth. In consideration of the irrevocable rights in them vested hereunder and the promises of the several sub-

scribers, J. P. Morgan & Co. have become parties to, and in good faith will endeavor to consummate the purposes of this agreement; and, after receipt thereof from the Steel Company, they will, as herein provided, deliver to the Syndicate the said Five Per Cent Gold Bonds, or the proceeds thereof, and the said cash compensation.

In witness whereof, the parties of the first part have hereunto affixed their signatures, and the parties of the second part at various dates have affixed their subscriptions hereto, it being understood that for convenience this agreement may be subscribed in several parts and copies with the same force and effect as if all the subscriptions were on one part or copy thereof.

SUBSCRIPTION FOR FIVE PER CENT GOLD BONDS

Name	Address	Preferred Stock	Cash

171. *Characteristics of syndicate agreements.*—The most prominent feature of this agreement, as the reader has no doubt observed, is the absolute and unrestricted authority retained by the managers of the syndicate. Such phrases as "J. P. Morgan & Company shall have full power in their discretion," "J. P. Morgan & Company shall be the sole and final judges," "J. P. Morgan & Company shall have authority from time to time and at any time," "J. P. Morgan & Company, in the exercise of their unrestricted discretion," and so on, abound. In this respect the agreement is typical of all underwriting syndicates. Indeed, it is easy to see that without such unrestricted authority the syndicate managers could not carry on their operations with the necessary promptness and secrecy. The real check to any abuse of this power is to be found in the necessity resting on each banking firm to preserve its reputation for integrity absolutely unstained.

For the same reason this agreement, like most other

such agreements, is marked by open dealing, so far as the essential things are concerned. At the very beginning of the agreement J. P. Morgan and Company state the commission which they are to receive. There is nothing on their part concealed from the other syndicate members; they state clearly what their profits and what the profits of each member are to be. The same rule holds true even in cases where the original underwriter is to make an extra profit over and above what goes to the other syndicate members. Secret profits are not permissible under the code of ethics that governs underwriting transactions.

Sometimes it happens that one of the underwriting firms finds its allotments too large for some reason, in which case it will probably form a sub-syndicate. The members of the sub-syndicate are usually individuals or smaller banking firms. They are not brought into contact at all with the original syndicate and have no part in its workings, but are responsible solely to the other members of the sub-syndicate.

172. ***Functions of underwriting syndicates.***—Underwriting syndicates may handle the securities of

(a) Established corporations.
(b) Reorganized corporations.
(c) New corporations.

The first case is the one that has been kept in view so far in this discussion and need not be further considered. The second case presents some points of difference which will be referred to in the chapters dealing with reorganization. In both cases the syndicate is handling investment securities and its sole problem is to market those securities to the best advantage. The third case is closely allied with promotion; the syndicate methods in this case require some further consideration.

173. *Underwriting speculative securities.*—The securities of a new corporation, no matter how brilliant its prospects may be, are almost always speculative; the only exception is when a new corporation is formed to take over a business already established, and this exception we need not consider here. The first distinction, then, between a syndicate formed to underwrite the securities of a new corporation and other syndicates is that it is handling stocks and bonds of doubtful value which it cannot recommend unreservedly.

A second distinction is that the syndicate must be prepared to put up more cash or furnish more credit in proportion to the size of the security issues than would ordinarily be necessary. This follows from the fact that conservative banks are not willing to lend much money on speculative stocks and bonds.

A third distinction is that the syndicate must be prepared to carry the proposition through to the end; in no other way except at an enormous sacrifice can the money needs of the new corporation be met.

A fourth distinction lies in the fact that for their own protection the syndicate members must build up and maintain the credit of the new corporation.

Evidently there are several difficult and dangerous problems here to be solved. It is essential to their solution that the syndicate should absolutely control the new corporation. Without control measures may be taken that will impair the credit of the corporations and bring heavy losses upon the syndicate. Even with full control such enterprises are usually deemed too risky to be participated in by banking houses of the best class. At least if such houses do enter the syndicate they accept only small allotments, knowing full well the danger of becoming more deeply involved as the enterprise pro-

ceeds. No one can tell in advance what the cash requirements of a new corporation may be.

Each enterprise of this nature has its own variations of the difficulties and dangers that have been cited and requires a solution that will exactly fit its own peculiarities. Perhaps the best way of explaining the usual solution will be to present the facts of a particular instance with which the writer happens to be familiar.

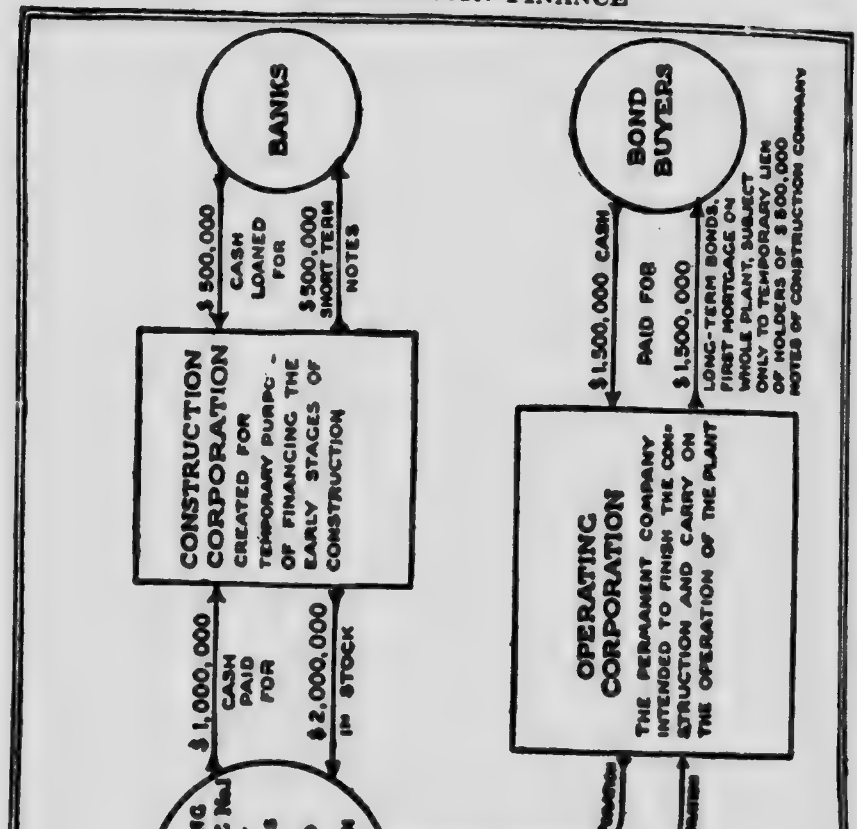
174. *An example of speculative underwriting.*—In the spring of 1902 the promoter of a smelting and refining company in Mexico succeeded in convincing a number of Philadelphia financiers that his proposition was worth looking into. They made a thorough investigation, satisfied themselves that the proposed plant would certainly prove profitable, and undertook to finance its construction. Engineers' estimates called for an expenditure of something over $2,000,000 and a period of three years before the plant would begin to earn expenses. As a matter of fact, the expenditure was approximately $3,000,000 and the construction work was not completed until early in 1907.

A syndicate of Philadelphia and Baltimore capitalists and banking houses was formed to underwrite the enterprise. Next an entirely different syndicate of banking houses was organized, which agreed to take the notes when issued up to a certain amount of syndicate No. I, the notes to be secured by the stock of a corporation organized to construct the plant. The corporation was capitalized at $2,000,000, half preferred and half common stock. All its stock was sold to syndicate No. I, for $1,000,000. Syndicate No. I then posted the stock and gave notes to syndicate No. II, which loaned the $1,000,000. Thus syndicate No. I was not called upon for cash, except for expenses, and the construction

company was supplied with $1,000,000 with which to begin operations.

Next, after expending the $1,000,000, the construction company issued $500,000 of its own notes, which being its only obligations were accepted by Philadelphia banks. The discount on this and the other sales, for the sake of simplicity, we will eliminate. Up to this point one-half the necessary funds had been secured and at the end of two years the work of construction had been more than half completed. Now a new corporation was formed which was to operate the plant. The reader will observe that the first corporation existed simply to carry on construction. The operating corporation at once took over the stock of the construction company, title to which up to this time had remained with syndicate No. I. Then the operating corporation put out a first-mortgage bond issue, based on all its property then owned and thereafter to be constructed, and sold during the next two years $1,500,000 bonds. In this way the whole $3,000,000 necessary to built the plant was raised by borrowing and the members of syndicate No. I furnished nothing to the enterprise but their credit. The diagram on page 334 will perhaps assist the reader in arriving at a clear understanding of the whole series of transactions.

The plant at the date of writing has been running a little over two years. Earnings have been more than sufficient to meet all interest charges and other expenses, and it is expected that large profits will be earned in the future. Although the enterprise is not yet beyond the speculative stage, its chief difficulties have been overcome and its prospects appear bright. The first use to which surplus earnings will be devoted, according to the present plans, will be the paying off of the $1,000,000 of notes issued by syndicate No. I, and of the $500,000


BANKS
$500,000
CASH LOANED FOR
$500,000 SHORT TERM NOTES
CONSTRUCTION CORPORATION
CREATED FOR TEMPORARY PURPOSE OF FINANCING THE EARLY STAGES OF CONSTRUCTION
$1,000,000
CASH PAID FOR
$2,000,000 1st STOCK
UNDERWRITING SYNDICATE No.1
MADE UP OF FINANCIERS DIRECTLY INTERESTED IN THE PROPOSITION
ALL STOCK OF OPERATING
EXCHANGED FOR ALL STOCK OF
$1,000,000
CASH LOANED FOR
$1,000,000 IN PERSONAL NOTES WITH STOCK OF CONSTRUCTION COMPANY AS COLLATERAL
UNDERWRITING SYNDICATE No.2
MADE UP OF BANKING HOUSES
BOND BUYERS
$1,500,000 CASH
PAID FOR
$1,500,000
LONG-TERM BONDS, FIRST MORTGAGE ON WHOLE PLANT, SUBJECT ONLY TO TEMPORARY LIEN OF HOLDERS OF $500,000 NOTES OF CONSTRUCTION COMPANY
OPERATING CORPORATION
THE PERMANENT COMPANY INTENDED TO FINISH THE CONSTRUCTION AND CARRY ON THE OPERATION OF THE PLANT

notes of the construction company. As soon as these obligations are met the construction company may be dissolved and the operating company will begin to pay, it is expected, big dividends.

It may seem strange that a new plant could thus be constructed wholly with borrowed funds; yet there is nothing especially unusual about the operation. The secret of the success of the syndicate in this instance lay in the fact that they were themselves strong financially and could borrow the first $1,000,000 readily. This left a margin of safety to those who loaned funds directly to the two corporations. Furthermore, the syndicate members were shrewd and prudent enough not to use up all the available credit of their corporations at the beginning. On the contrary, the essential feature of their plan of operation was to leave the best lien till the last. Thus they were able to borrow $1,500,000 on first mortgage bonds at a time when most corporations under ordinary management would have been compelled to call on their stockholders for funds.

Much more complicated instances might have been cited. The principles followed in all those that have proved successful, however, have been the same, namely: utilize the credit of the backers of the corporation at the beginning and save the best security that the corporation can offer till the end. Working in this way, the underwriting syndicates of new corporations frequently borrow large sums on advantageous terms.

CHAPTER XXI

INVESTMENT OF CAPITAL FUNDS

175. ***The importance of wise investment.***—The next question that confronts the promoter or manager of a new corporation after he has succeeded by one means or another in raising the necessary funds is, How shall those funds be invested? This seems a very easy problem at first sight; and indeed the simple process of investing is easy enough. To invest capital funds wisely and to the best advantage for the future of the corporation, however, is a task that requires careful thought and foresight. A great many mistakes are made just at this point. The causes of failure of a great many failed corporations may be traced back unquestionably to errors in the original investment.

Of course, each corporation has its own peculiar conditions to meet and no general principles can be laid down that will take the place of keen observation and careful reflection over all factors in the particular situation that each manager faces. Nevertheless, there are some principles with regard to investment of capital funds so universal and some fatal errors so common that a short study of the problem is evidently worth while. Even if the result of this study is only a series of generalities, still experience shows that these generalities are worth making and worth keeping constantly in view.

176. ***The installment method of getting cash as needed.***—In the first place, a new corporation as a rule does not require all of the capital funds that will be nec-

essary for its development at the outset. On the other side, as we emphasized in connection with the subject of promotion, the corporation managers should have in sight from the very beginning all the capital funds that they are likely to need; for an effort to raise additional capital for an enterprise that is only half or two-thirds completed, and not on a paying basis, is painful and frequently unavailing. The manager or promoter of the corporation, then, looks for some method of reconciling these conflicting requirements.

The simplest and best method, from the corporation's standpoint, is to obtain subscriptions before the new concern is started for more than enough stocks and bonds to carry it through to success, but to have the cash for these securities payable in installments. This method is common and works very well with enterprises, the total capital cost of which can be accurately estimated in advance—such enterprises, for instance, as the erection of an office building or the construction of a railroad. In such cases the installments may be certain definite percentages due at days fixed in advance, say 10 per cent when the corporation is organized, 25 per cent at the expiration of three months, 25 per cent at the end of six months, 20 per cent at the end of nine months, and the remaining 20 per cent at the end of a year. In this way the sale of securities is facilitated, because buyers prefer usually to pay in installments, and the corporation gets its funds as needed.

The case is quite different, however, when the total amount of capital funds needed cannot be foretold. A corporation may be formed, for instance, to open up a mine or construct a tunnel or start a magazine. Nobody can foresee absolutely what obstacles the underground work of the mine or tunnel will encounter, or

how quickly the magazine will "take" with the reading public. The promoter of such an enterprise, if he is honest with himself, will recognize that the corporation perhaps may need less and probably will need a great deal more capital funds than he anticipates. In order to meet this situation he will, if he can, induce people to subscribe capital funds to an amount greater than will probably be needed, issue part-paid stock when installments to a certain amount, say 50 per cent, have been paid and make the rest of the installments payable at the option of the corporation. Thus the corporation can get all the funds it needs and at the same time does not have to carry large sums for which it has no particular use. This is the ideal arrangement for such a corporation.

177. *Disadvantages of this method.*—Unfortunately this plan does not appeal to the average stockholder. He does not like the idea of being liable at all times for the unpaid installments, particularly as the calls for additional payments in many such enterprises are apt to come during periods of financial distress at the very time when it will be extremely disagreeable for him to meet them. Moreover, in large corporations such an arrangement gives to the managers of the corporation an opportunity for manipulation that they are not always virtuous enough to resist. Take the case, for example, of a well-known street railway company, which may be recognized by some of our readers, but whose name it would be improper to give in this connection: This company has a very large amount of part-paid stock outstanding, the remaining installments being due and payable at the option of the board of directors. It is strongly suspected that the board on several occasions have agreed among themselves in advance to issue a call

for an installment and have thus given themselves plenty of time to accumulate cash. Then the call has been issued and the installment made payable at a very early date, so as to make it difficult for most of the stockholders to meet the call. The result naturally has been in each instance that considerable amounts of the part-paid stock were thrown on the market and bought up at bargain prices by the directors and their friends. With the funds received from the installments the corporation has been in position to put its property in good condition and show excellent earnings for a year or two, thus allowing the directors to sell stock at high prices. After it was distributed the directors have issued another call and have repeated the milking process. Experiences like this have made buyers of securities very cautious in the purchase of part-paid stock. Generally speaking, it is a difficult thing to sell any stock that is not labeled "full paid and non-assessable."

178. *Other possible methods.*—It follows that the managers of a corporation, the needs of which for capital funds cannot be estimated in advance, are driven to take one of two courses: either they must sell at the beginning a far greater amount of securities than will probably prove necessary, and put their idle fund to some use outside the original purpose of the corporation, or else they must trust to luck that they will be able to sell more securities when additional capital funds are needed. Neither one of these alternatives is free from serious objections.

Here, then, is the first great problem in connection with the investment of capital funds, that of getting the funds when and if they prove to be needed. If that problem is not solved in just the right manner, either the corporation will have more funds on hand than it

needs and its rate of profits on stock will thereby be diminished, or else it will not have enough funds and its development will thereby be checked.

179. *How much shall be invested in fixed capital?*—The next question to consider is, What proportion of the capital funds shall be put into "fixed" and what into "working" capital? The distinctions between fixed, semi-fixed, current and quick assets were discussed in Chapter VII. The fixed and semi-fixed assets together—those assets, in other words, which cannot be readily converted into cash—constitute the corporation's fixed capital. Working capital is somewhat different. It consists, not of the current assets, but of the difference between current assets and current obligations. In other words, it consists of that amount of current assets which is not furnished by trade and other short-time creditors and by temporary bank loans.

The amount of fixed capital required by any corporation depends, of course, on the nature of its operations. Industrial and mining corporations must have machinery; railroad companies must have track and rolling stock; trading companies must have office furniture before they can start business. The necessary total of fixed capital is not always so great as it appears to an outsider, for the reason that in most enterprises land, buildings and even machinery can be rented to better advantage than they can be bought. Accountants recognize this fact and are in the habit, in estimating the true cost of production in a manufacturing establishment, of charging an estimated rent for the land and buildings even though they be owned in fee by the corporation. It is well for corporation managers to consider this possibility, especially in starting a new enterprise, and where possible avoid the investment of

large sums in fixed assets until after the success of the enterprise is assured.

One of the characteristics of fixed capital is that, although it may be essential and valuable to the corporation which owns it, it is likely to have very little value if put on the market for sale. Its value remains, in other words, only so long as the concern is "going." Therefore, the smaller the proportion of a corporation's capital invested in fixed assets, the better off it is in case of failure or bankruptcy.

180. *Forms of working capital.*—Working capital may take any or all of four forms:

(1) Cash, either on hand or in banks.

(2) Bills and accounts receivable.

(3) Raw materials and finished products in stock.

(4) Securities of other corporations held, not for control, but for temporary investment.

As an illustration take the following table, which shows the current assets and current liabilities of the United States Rubber Company for two recent fiscal years, as shown on the published balance sheets, and the working capital, or excess current assets over current liabilities:

CURRENT ASSETS.

Inventories	$18,404,726	$13,533,169
Cash	2,061,401	2,723,380
Bills receivable	3,681,126	994,250
Accounts receivable	8,687,631	8,494,234
Totals	$32,834,884	$25,745,033

CURRENT LIABILITIES.

Loans and notes payable	$ 6,821,077	$ 2,440,077
Accounts payable	737,384	362,634
Due General Rubber Co	7,269,441	7,164,111
Reserve for discount	872,989	874,735
Totals	$15,700,891	$10,841,557
Working capital	$17,133,993	$14,908,476

181. *How much working capital shall be carried?*—The amount of actual cash needed by a corporation varies with the size of its pay-roll and other current demands for cash, with the amount and character of its accounts payable considered in connection with its accounts receivable, with the discounts that it may obtain on purchases by making cash payments, and with its facilities for securing temporary loans. The force of these considerations must be estimated by the corporation managers. Obviously there is a waste in carrying unnecessarily large bank balances; if any interest is received on such balances, it will not usually run higher than 3 per cent. On the other hand, every corporation naturally desires to stand well with banks and will carry large enough balances to make its deposits worth having. Otherwise, the corporation in times of difficulty may turn to banks in vain for temporary assistance.

The amount of accounts receivable cannot be determined by the financial management of a corporation, but depends on the volume of sales, on the custom of the trade as regards payment and on the efficiency of the credit department in granting credits and in making collections.

The amount of finished products and raw materials on hand is directly determined, of course, by the operating department of each company. Nevertheless, the executive heads of the company should and usually do

exercise some discretion in this regard, particularly with a view to reducing the amount of working capital thus invested to a minimum. A great many manufacturing corporations, on account of improper purchasing and accounting methods, are wasteful in this regard. Careful perpetual inventories of goods in stock will often make it possible to buy and sell more closely without interfering in the least with the operating efficiency of the business. Although this is a topic which belongs rather to organization and accounting than to finance, its importance to a corporation's financial management should not be overlooked.

182. *The practice of large corporations.*—The following compilation made by the *Wall Street Journal* is of particular interest in that it shows the practice with regard to working capital of the largest and best-managed corporations.

> A study of reports of the leading industrial companies shows that the United States Steel Corporation takes the lead in working capital, with the Standard Oil Co. second, the International Harvester Co. third and the General Electric Co. fourth.
>
> Including sinking and reserve fund assets invested in securities, amounting to $32,442,400, the working capital of the U. S. Steel Corporation is $261,789,885.
>
> The International Harvester Co., aside from the Standard Oil Co., probably has a larger working capital to gross business than any other corporation of consequence. Its working capital as of December 31, 1907, aggregated $77,087,811, while its gross business amounted to only $78,206,890.
>
> The General Electric Co. also shows up well from the standpoint of working capital, reporting $61,235,724 on January 31 last, compared with its gross business of $70,977,168.
>
> The following table gives the working capital of several of the prominent industrial companies, together with gross business and capitalization:

Company.	*Gross Business.*	*Working Capital.*	*Capital Stock.*
United States Steel Corp'n..	$757,014,767	*$261,[illegible]885	$868,583,600
Standard Oil Company ...	....	250,000,000	100,027,150
Inter. Harvester Company	78,206,890	77,087,811	120,000,000
General Electric Company	70,977,168	61,235,724	65,167,400
West. Elec. Mfg. Company	33,026,240	19,061,807	24,969,000
Lackawanna St'l Company	33,011,410	13,881,340	34,721,400
Republic I.&St'l Company	31,229,423	6,720,000	47,607,900
Bethlehem Steel Company	15,000,000	7,434,573	29,770,000
Am. Steel Found. Company	19,463,521	4,834,843	17,184,000
Midvale Steel Company	....	1,804,929	750,000
Allis-Chalmers Company	....	12,522,074	35,790,000
Cambria Steel Company	....	14,597,865	45,000,000
Total		$730,970,851	$1,389,570,450

The above figures show that the twelve companies in question are well fortified with working capital. The aggregate working capital stands at $730,970,851, as compared with total stock capitalization of $1,389,570,450.

The figures given above indicate that the companies in question are in a strong position to weather any depression that may reasonably be expected.

* Includes sinking and reserve fund assets amounting to $3[illegible],448,401.

To invest working capital to any considerable amount in the securities of other corporations is not a very common or commendable practice. It is justifiable only in those companies that have great fluctuations in demands for cash and that cannot secure fair interest on bank balances. The buying and selling of securities is no part of the business of any corporations except the few which are distinctly organized for that purpose. Profits that are derived from this source are justly regarded as speculative and highly uncertain.

183. *Factors that affect working capital.*—Considering the situation as a whole the proportion of working to fixed capital in any business may be said to depend upon five factors, as follows:

(1) Volume of business.

(2) The regularity of supply of whatever raw materials are used and the savings which may be effected by buying raw materials in large quantities. If it is necessary for the corporation to pick up large batches of raw materials at irregular periods in order to get advantageous terms, of course the working capital must be correspondingly increased, for two reasons: first, because larger amounts of raw materials must be carried in stock than would otherwise be necessary; second, because larger bank balances must be maintained in order to meet these irregular demands.

(3) Regularity of the demand for the product of the corporation. The same considerations apply here as were named in connection with the preceding factor.

(4) Customs of payment in the business. Some manufacturing corporations normally buy on 90 days' time and sell on 30 days' time. This arrangement makes it possible to meet the accounts payable out of accounts

receivable and lessens the necessary amount of working capital.

(5) The length of time required to turn out the finished product. It takes three or four years normally to build a big steam vessel. During that period the ship-building corporation will necessarily pay out large sums for lumber and materials and a big working capital, therefore, will be necessary. The same remark applies to all concerns in which the period of manufacture is lengthy.

There is one great industry of the United States which can usually get along with a very small proportion of working capital, namely, railroad operation. The prime reason is that the railroads are manufacturing a commodity, that is, transportation, which is continually in demand and which is paid for ordinarily as soon as it is produced. There are no outlays to speak of for current raw materials; the only raw materials that railroads use are for fixed assets and may be regarded as part of the cost of securing fixed capital.

184. *The working capital of the Pennsylvania Railroad.*—Even among railroads there may be exceptional circumstances which make necessary large working capitals. The Pennsylvania Railroad, for example, in the early part of 1909 was completing its immense terminal improvements in and near New York City. In a sense it was engaged in the contracting business on a great scale, for it was building tracks, tunnels and stations. Therefore, it needed temporarily as much working capital as a manufacturing corporation should have.

Making a strict classification of current assets and liabilities, the Pennsylvania Railroad's cash position at the end of 1908 compared with its position twelve months before as follows:

CURRENT ASSETS.

	1908	1907	*Changes*
Cash	$56,025,898	$37,385,673	Inc. $18,640,225
Bills & accts. recv.	14,294,080	18,069,840	Dec. 3,775,760
Cash assets	$70,319,978	$55,455,513	Inc. $14,864,465

CURRENT LIABILITIES.

	1908	1907	*Changes*
Payrolls & vouch.	$14,227,369	$20,226,164	Dec. $ 5,998,795
Int. accrued, etc.	3,231,248	2,875,982	Inc. 355,266
Miscellaneous	4,211,496	3,966,996	Inc. 244,500
Current liabilities	$21,670,113	$27,069,142	Dec. $ 5,399,029
Excess cur. assets	48,649,865	28,386,371	Inc. 20,263,494

This makes the company's net free capital, subject to the company's need of money to carry on its everyday business of transportation, more than $48,000,000 and $20,000,000 in excess of what it had been the year before. The other assets, not to be classed as quick items but more or less subject to liquidation in time, and deferred and contingent liabilities, compare as follows:

DEFERRED AND CONTINGENT ASSETS.

	1908	1907	*Changes*
Due on N. & W. & C. & O. stocks	$15,492,685	$15,492,685	....
Loans for cons., &c.	12,403,834	18,412,493	Dec. $ 6,008,659
Due from controlled companies	3,159,784	462,218	Inc. 2,697,566
Materials on hand	10,449,483	15,929,925	Dec. 5,480,442
Sink. fund assets	8,148,208	7,772,627	Inc. 375,581
Total	$49,653,994	$58,069,948	Dec. $ 8,415,954

DEFERRED AND CONTINGENT LIABILITIES.

	1908	1907	*Changes*
Car trusts chgd out	$ 2,043,803	$ 1,424,871	Inc. $ 618,932
Taxes chgd out	2,731,109	3,023,197	Dec. 292,088
Due Penna. Co.	....	2,290,807	Dec. 2,290,807
Extr. exp. fund	....	2,500,000	Dec. 2,500,000
Sinking fund liab.	10,339,057	9,815,956	Inc. 523,101
Total	$15,113,969	$19,054,921	Dec. $ 3,940,952
Excess def. & con. assets	$34,540,025	$39,015,027	Dec. $ 4,475,002

185. *General conclusions as to working capital.*—Many other industries, particularly those manufacturing staple articles of trade, require a comparatively small proportion of working capital. On the other hand, there are lines of business, such, *for* instance, as publishing, in which only a little fixed capital (office furniture, plates, etc., chiefly) is needed. This is true more or less of all trading corporations.

As was intimated at the beginning of this chapter, the principles herein laid down are of a very broad and general nature and can be successfully applied only by keen intelligence. Perhaps the chief practical conclusion is that the most careful thought must be given to securing a proper proportion of working capital. No matter how valuable the fixed assets of a corporation may be, if it does not have all the funds necessary to transact current business and to meet current obligations, it will inevitably prove a failure. Right here is where most of the mistakes and failures of the early stages of corporate management occur. Managers trust that the current sales will take care of current expenses; when the inevitable hitch occurs they have no other resources to use and the corporation suddenly plunges into the quicksands of financial trouble and discredit. This problem of providing sufficient working capital will crop out again when we come to consider the causes of corporate insolvency.

CHAPTER XXII

DISPOSITION OF GROSS EARNINGS

186. *Determination of income.*—The ordinary form of income statement of a corporation is somewhat as follows:

(a) Gross earnings from operation or manufacture.
(b) Deduct operating or manufacturing expenses.
(c) Net earnings from operation or manufacture.
(d) Add income from other sources.
(e) Total income.
(f) Deduct taxes.
(g) Balance applicable to fixed charges.
(h) Deduct interest.
(i) Deduct rentals.
(j) Deduct sinking fund and other charges.
(k) Balance applicable to dividends and surplus.
(l) Deduct dividends.
(m) Surplus from the year's operations.

It goes without saying that each corporation has its own method of stating accounts and that there are many variations from this standard form. The essential items, however, are those stated above. It would be well for the reader to study with some care the income accounts of large corporations which are made public from time to time and which are printed in the financial columns of all metropolitan newspapers. If any of the items given above are not altogether clear, the reader

should turn to the volume on ACCOUNTING PRACTICE and go over the explanation there given of the income statement.

The relations between accounting and finance are so close that a fair understanding of the basic principles of accounting is necessary in order to deal intelligently with the problems of financial management. In what is said below in reference to each of the items in the income account it will be assumed that the reader is familiar with accounting terms and with the elements of accounting practice.

187. *Honesty in stating gross earnings.*—Perhaps the only comment needful on the first item "gross earnings" is that it should be honestly stated. This remark is trite enough, and yet not uncalled for. A great many corporation managers are in the habit of including in their gross earnings sales that have been made to parties of doubtful credit which are represented merely by accounts receivable that are probably bad. In the case of holding companies it is not so uncommon as it should be to include in the gross earnings sales made from one company to another in the combination. Of course this is simply a juggling with figures. A still more flagrant instance of dishonesty was disclosed by Mr. Stephen Little, an accountant of wide reputation, who in 1894 was called upon to investigate the condition of the insolvent Atchison, Topeka and Sante Fe Railroad Company. Mr. Little found that the railroad had paid out millions of dollars in rebates to shippers which had not been deducted from its statement of gross earnings.

188. *What are operating expenses?*—Operating expenses are also often grossly misstated, although in this instance the fault is apt to be due, not so much to the

dishonesty of the corporation managers, as to their ignorance of correct accounting principles. The operating expenses ought always to include not only the actual expenditures for raw materials, labor and current repairs, but also a liberal allowance fcr anticipated repairs and renewals and for depreciation.

Repairs in the early years of a corporation's activities are seldom as great a burden as in later years. Accountants figure that most manufacturing machines will show a rising percentage of necessary repairs each year for the first five to ten years of their existence and after that a fairly steady ratio will be maintained. Now it is evident that unless some allowance is made during the first few years for the rise in this item during the following years, a misleading statement of operating expenses will be presented.

Corporations differ greatly in their handling of charges for renewals of machinery and equipment. Many of them figure that the new machines they buy are additions to their capital and therefore should not be charged against the income account at all. If the new machine, however, replaces to any extent an old machine, this reasoning is obviously incorrect. Only the difference between the value of the old and the value of the new machine could properly be charged to capital account. Conservative corporations in this country, railroads particularly, are in the habit of charging the whole cost of the new equipment, as a rule, as a part of operating expenses. The English railroad practice, on the other hand, is to charge the whole expense to capital and to raise new capital funds to meet it. We shall have occasion to consider this point further in connection with "betterment expenses."

189. *Necessity for depreciation reserves.*—The sub-

ject of depreciation is too large and important to receive full consideration in this place; a more extended treatment will be found in the volumes on accounting. As the desirability of allowing properly for depreciation ought to be indelibly impressed on the mind of every person interested in corporation management, however, some brief remarks on the subject, even at the risk of reiteration, are worth making here.

There are three general causes of depreciation, as follows:

(a) Failure to keep property in first-class working condition.

(b) The gradual breaking down of property in spite of all that may be done to keep it in good condition.

(c) Most important of all, obsolescence or the impairment of value because of new inventions and processes.

It is difficult for anyone not directly familiar with modern manufacturing enterprises to conceive of the rapidity with which changes in mechanical methods follow each other. Each important change is apt to make necessary a general revision of all the machinery and processes of manufacture. In the intense competition between industries, no concern that allows itself to fall behind in the race to install the latest and most economical devices will long be able to survive. American manufacturers have long been famous for the vigor and fearlessness with which they adopt new machinery and processes, even though the change may make almost worthless the expensive equipment that had previously been installed. The Carnegie Steel Company, it is said, time after time, has relentlessly sent to the scrap heap costly machines and even whole plants that were found to be inferior to new inventions.

This policy certainly pays in the long run, as the striking success of the Carnegie Steel Company shows. Where products are being turned out in great quantities, a very slight saving in the cost of producing each unit may prove to be the margin between bankruptcy and prosperity. Yet, though the policy is to be praised and followed, it must not be forgotten that it involves large losses for the time being whenever old machines are superseded by new. These losses ought to be foreseen and provided against when the first step of an enterprise are taken. The only possible means of so doing is to charge as part of the operating expenses every year a liberal sum of depreciation—a sum that will take care, not merely of decay due to old age and lack of repair, but of obsolescence as well.

Anything like a scientific treatment of depreciation has unfortunately been conspicuously absent from the accounts of most American corporations. Manufacturers have been too willing to make rough guesses where fairly exact scientific deductions might have been drawn. Electric and steam railroads have uniformly declined to make any allowance whatever for depreciation on the ground that the value of their franchises is steadily rising and that this is sufficient to offset whatever depreciation of their property is going on. There is a certain amount of truth, to be sure, in this assertion; yet it reveals a woefully careless habit of thought. Such slap-dash methods fortunately are now being eradicated, so far as interstate steam and electric lines are concerned, through the control over their accounts now exercised by the Interstate Commerce Commission. Recent rulings of the Commission have very properly made it obligatory on railroads to form as accurate estimates as they can of annual depreciation of their

property and to set aside every year as part of operating expenses an adequate depreciation charge.

To avoid any possible misunderstanding by those who may not be familiar with accounts, it may be well to state at this point that depreciation reserves, so called, are not sums set apart and invested outside of the property, but are merely the total charges against gross earnings over a series of years on account of depreciation. The depreciation reserves are not separable from other capital funds invested in the business except as a matter of accounting.

190. *Income from other sources and deductions.*—We have now reached in our income statement the item "net earnings derived from operation." To these earnings should be added "income from other sources." In order to make the income account a clear and accurate statement of results of the year's operations, it is very important that this "income from other sources" should be stated separately and not confused with "net earnings from operation"; otherwise the corporation managers will be claiming credit for returns that are quite distinct from the company's own operation. Income from other sources includes dividends on the stocks of subsidiary and other companies, interest on the bonds of such companies, interest on bank deposits, rentals of property owned by the corporation and not used in its own operations, and other items of that nature. Such returns are frequently temporary or irregular, in which case, in order to make the situation clear, they ought to be specifically named in the income statement.

We now deduct taxes which, it will be noted in our model income statement, should not be included under fixed charges. There is some difference of opinion on

this point. It is not a matter of sufficient importance, however, to be worth arguing over. The view here taken is that taxes are variable in amount, and are not, therefore, on the same basis as the regularly recurring fixed charges.

As to the nature of interest and rentals, little need here be said. Sinking funds have been sufficiently treated for our purpose in another place.

The deduction of fixed charges leaves as a balance the income applicable to dividends and surplus. Preferred dividends, as have previously been explained, are classified as cumulative and non-cumulative. Cumulative dividends, to the corporation managers, are often extremely disagreeable things. They are not so bad as interest charges, for they may be deferred as often as necessary. On the other hand, the fact that they are cumulative makes them pile up at an alarming rate, and in the course of a very few years, if they are not paid, they become a charge ahead of the common stock that makes common stock dividends seem an unattainable vision. For the best interests of common stockholders, therefore, it is usually very desirable to pay cumulative preferred dividends regularly. If a shrinkage in profits makes a temporary lapse necessary, the lost ground should be regained at the first opportunity.

191. *How much shall be paid out in dividends.*—The next question to consider in disposing of the earnings of a corporation is, How much shall be paid out in non-cumulative and in common dividends. Mr. Thomas F. Woodlock has well said that the payment of dividends is the only absolutely non-productive expenditure that an honest corporation makes. This may sound like a meaningless paradox, but it is literally true. So far as the corporation itself is concerned, whatever is paid out

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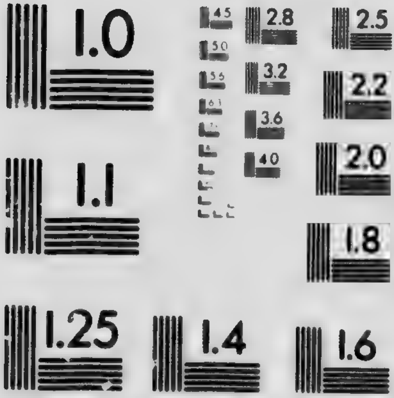

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in dividends is a total loss. On the other hand, it is also true that the only reason for the corporation's existence is that it may pay dividends to the stockholders. There is a conflict of interest here evidently and often a strong conflict of opinion between the managers of a corporation and the stockholders as to whether dividends should be paid or not. In the next chapter some striking examples will be cited.

Assuming that a corporation has a balance for the year applicable to dividends and surplus, and that all persons concerned are agreed that some dividends should be paid, the question takes the form, How large an amount shall be thus distributed to stockholders? The first and most natural answer to this question is that all the profits of each year belong to the stockholders and should be paid out in dividends; and this answer is deemed entirely satisfactory by many intelligent people. The English corporations almost invariably follow this practice, and some important American corporations as well. The New York Central Railroad Company, for instance, has for many years paid out in dividends each year almost all the net earnings of the year.

There are two distinct disadvantages in this practice: First, it does not permit the corporation to create a surplus of any considerable size; second, it makes the dividend rate irregular. The first disadvantage will be more fully discussed in Chapter XXIII. The second disadvantage is of great importance and calls for some explanation.

192. *Variability of profits.*—In all lines of business the profits necessarily vary from year to year. This is true because all the factors which enter into and determine profits are variable. These facts are:

(a) Volume of sales.
(b) Prices obtained.
(c) Prices of raw materials.
(d) Wages.

In no line of business is the volume of sales the same from year to year and in no line even where the general trend is upward can the volume be expected to increase steadily and regularly. Some fair degree of regularity, to be sure, can be attained in the cases of large public service corporations, such as waterworks, street railways and steam railroads, that deal with great masses of people. Even here there are sometimes surprising fluctuations. In most lines of industry, prices are very unstable and show big variations from year to year. In general it may be said that those industries have the most regular prices and volume of sales which are concerned with the necessities of life; and the farther you get away from those necessities, the more violent are the fluctuations in those two items.

To make these statements more definite let us examine the records of some of the leading industrial, street railroad and steam railroad companies during the year of depression, 1908. The following gives the percentage of production of the leading industrial companies, compared with normal:

United States Steel Corporation	60
Republic Iron and Steel	90
Lukens Iron & Steel	60
Corn Products Refining	75
Standard Oil	95
General Electric	60
Westinghouse	60
Pennsylvania Steel	60
Maryland Steel	60

Jones & Laughlin	55
Amalgamated Copper	100
National Lead	95
American Smelting & Refining	80
Sloss-Sheffield Steel & Iron	80
International Paper	70
United States Rubber	75
Allis-Chalmers	65
American Can	75
American Car & Foundry	35
Pressed Steel Car	20
Railway Steel Spring	75
American Locomotive	40
Bethlehem Steel Corporation	50
International Harvester	100
United States Realty & Improvement	100

Orders for new railway equipment in 1908 were less than 40 per cent of those received during 1907 and hardly 20 per cent of orders booked in the big rush of business in 1905. The course of new business during the preceding four years may be gathered from the following comparison:

Year	*Loco. Orders*	*Fgt. Car Orders*
1908	1,182	62,700
1907	3,282	151,700
1906	5,642	310,315
1905	6,265	341,315

In striking contrast is the record of the following railroad and street railway companies. Notice particularly the small fluctuations in the street traffic in large cities. The decrease in street railway gross earnings was less than 1 per cent and in steam railroad gross earnings about 19 per cent.

ELECTRIC STREET RAILWAYS.

Company and Period	1908	1907	*Decrease.*
Boston, May-July	$ 3,596,000	$ 3,623,000	$ 27,000
Mass. Elec., Apr.-June	1,995,842	1,924,333	*71,509
Chicago Rys., Mch.-May	2,625,533	2,574,324	*51,209
Twin City, Apr.-June	1,474,389	1,492,671	18,282
United St. Louis, Mch.-May	2,645,364	2,735,406	90,042
Detroit United, Mch.-May	1,675,042	1,675,743	701
Total	$14,012,170	$14,025,477	$13,307

* Increase.

STEAM RAILROADS.

Company and Period	1908	1907	*Decrease.*
Lake Shore, April-June	$ 9,182,851	$11,160,400	$ 1,977,549
New Haven, April-June	10,913,741	12,670,010	1,756,269
Pennsylvania, Jan.-Mch	31,375,489	37,203,589	5,828,100
Louis. & Nashville., Feb.-Apr.	10,073,862	12,012,701	1,938,839
Missouri Pac., Feb.-Apr	9,467,500	11,927,824	2,460,324
Boston & Maine, Apr.-June	8,836,556	10,499,302	1,662,746
Total	$79,849,999	$95,473,826	$15,623,827

The explanation of the different manner in which the street railways and steam railroads have fared is largely to be found in the different character of their traffic. Street railway gross is 95 per cent derived from passenger receipts, while from 65 to 70 per cent of railroad gross is realized from freight; and in periods of universal curtailment freight earnings quickly feel the depression.

Even with an absolutely invariable volume of sales and level of prices any industry would still be subject to great variations in profits by reason of changes in raw material prices and in wages. This statement is obvious enough without any elaboration. It should be remarked that the amount of wages paid out is not dependent altogether on the nominal rate of wages, but also to a great extent on the efficiency of labor. When times are good and sales in all lines are heavy, it becomes

necessary to employ workingmen of an inferior grade, who in bad times are always "out of a job." Taking on such men means a great reduction in the average efficiency of labor and in economy of production.

193. *Regularity of dividends desirable.*—We are safe in saying, then, that great fluctuations in profits are inevitable in most lines of business and cannot be altogether avoided, even by the large public service corporations which furnish the necessities of life. It follows that if all the earnings each year are paid out in dividends, the rate of dividends will fluctuate—in many cases fluctuate violently. The reader may perhaps ask at this point, Why not let them fluctuate? Let the stockholders in a corporation take their profits as they are earned, just as the owner of an individual business or partner in a firm would do.

The answer to this question is that stock, and especially the stock of large corporations, is widely held by people of all classes who are not in touch with business affairs and not prepared to take care of haphazard returns that drop into their laps from time to time, but who desire above all things a steady, regular and dependable income. Such people do not want lean years and fat years; they want a series of moderately good years. They belong, not to the speculative, but to the investment class. On account of the demand that such people create for regular dividend-paying securities, the market prices of such securities are far higher than they would otherwise be. For example, take two stocks, one of which pays over a series of five years, 4 per cent, 7 per cent, 6 per cent, 3 per cent and 5 per cent, averaging 5 per cent for the period, and compare it with another stock which has regularly paid 5 per cent each year; you will always find a marked differ-

ence in market price in favor of the second stock. The principal reason for this difference is that so many people prefer a regular dividend payer.

It is for the best interests of all a corporation's stockholders to pay regularly a steady rate of dividend, inasmuch as the market price is thereby enhanced. The corporation manager, then, is confronted with the problem of reconciling this demand with the irregularity of the corporate profits. The only safe method of accomplishing this result is to pay out in dividends no more than the minimum earnings of the corporation in its worst years. Thus the dividends may always be kept at a fixed rate and whatever is earned above the dividend requirements will go into the company's surplus.

194. *Prudence in paying dividends.*—This may seem an unnecessarily harsh rule, for it keeps the rate of dividends low and thereby unnecessarily, it may seem, cuts down the stockholders' income. In the long run, however, it works no injustice. As we shall see in succeeding chapters, whatever surplus is saved out of income, goes to increase the company's earning power and eventually its regular dividend rate.

Looking back over the ground covered in this chapter, we see that great care, prudence and foresight on the part of a corporation directorate in the distribution of gross earnings is necessary in order to give permanence and long-continued success to the corporation. The board of directors must see to it that the gross earning of each year are not overstated and that operating expenses are not understated. In connection with the latter item they must take care that sufficient reserve has been set aside to provide for accrued repairs and for depreciation. They must, of course, meet all the fixed charges of the corporation out of income under penalty

of seeing the company forced into bankruptcy. They must pay cumulative preferred dividends so far as practicable, although in this regard some discretion is permitted to them. Finally they must resist unwise pressure from stockholders for larger dividends than the condition of the company in the long run will warrant. If they do not resist these demands, the company will be compelled probably sooner or later to reduce its dividend rate, thus removing its stocks from the class of desirable investments and lowering their market prices. The ideal corporation director will stand like Horatius at the bridge, defending the wealth and profits of the corporation from the onslaughts of hungry stockholders who do not possess either foresight or intimate knowledge of the business.

A corporation which has such a directorate is peculiarly fortunate and, whatever its line of business, may reasonably expect to attain a lasting success. A corporation which does not have such a board will perhaps prosper for a season and apparently enrich its officers and stockholders. In the end, however, it will prove to be but a mushroom growth. All the while its vitality is dwindling, its substance is being eaten out and sooner or later, to the surprise of unwary investors, it suddenly crumbles away.

CHAPTER XXIII

BETTERMENT EXPENSES

195. *Two classes of betterments.*—All improvements and all expansions of property may be grouped under the general name "betterments." The question as to whether betterments should be made or not is primarily something for the operating officials of the company to decide. They should understand thoroughly the condition of the property, the cost of the proposed betterments and the prospects for additional business, and from the study of these factors should be able to draw pretty definite conclusions as to their advisability.

All betterments may be roughly divided into two groups:

(a) Those which are practically certain to bring about an immediate increase in revenue.

(b) Those which are expected to prove profitable in the long run, but which may or may not bring immediate returns.

As an example of the first class, we may suppose that a manufacturing company is about to put in a new and expensive engine; in such a case the proper officials should be able to calculate in advance almost exactly the annual saving that will be made possible by this particular improvement.

As an example of the second class, we may suppose that the same company is considering the advisability of building a Young Men's Christian Association reading room and gymnasium for the benefit of their employes.

Their motives, we may presume, are not in the least philanthropic; they expect the investment to yield big returns in the form of a better satisfied and more intelligent force of workingmen. The extent of the returns, however, cannot be calculated exactly and in any case will not be immediate.

The dividing line between the two classes is not always very clear and there may often be more difficulty than in the two examples just cited in assigning a proposed betterment to its proper class. The classification, however, consciously or unconsciously, is almost always made by intelligent corporate officials and directors.

196. *Sources of funds for betterments.*—Once a betterment expense has been agreed to, the next question is how to raise the necessary funds. This is a purely financial question, which deserves even fuller consideration than is possible within our space limits. At bottom the problem of raising capital funds for betterments is of the same general character as the problem of raising the initial capital funds when a corporation starts business. There are, however, as we shall see, some important variations in the problem.

The sources of capital funds, whether at the beginning or during the corporation's existence, are the same as have already been given, namely:

(a) The active managers of the corporation.
(b) Surplus earnings.
(c) Trade creditors.
(d) Banks.
(e) The investing public.
(f) The speculative public.

For our present purpose we may eliminate sources (a), (c) and (d). There is nothing to be said with regard to them that has not already been said in Chapter

VII. There remain: source (b), from which the funds may be obtained by one of two methods, either direct appropriations from surplus, or abnormally high operating expenditures; source (e), which may be reached either by the issue of medium-term notes or by the issue of bonds; and source (f) from which funds may be obtained by the sale of new stock.

197. *Appropriations from earnings.*—The safest and surest known method for providing for betterments and building up any concern is by making appropriations out of earnings. Expansion that is financed in this manner will be very slow, to be sure, unless the profits of the concern are inordinately large. This very slowness, however, is in some respects an advantage. It necessitates a gradual growth, a kind of evolution of the business, and thus automatically provides against waste and recklessness. It is practically certain that any concern which is built up altogether or in large part by means of appropriations from each year's surplus will be conducting its business along conservative lines. That it is not impossible by this method to construct in time an immense and profitable concern is proved by the history of two of our great industrials, the Carnegie Steel Company and the Baldwin Locomotive Works. The Carnegie Company had its inception in 1871 in an insignificant steel-making plant which was bought with a few thousand dollars that Andrew Carnegie and his associates were able with great difficulty at that time to command. It has since expanded until it is to-day worth, as a going concern, perhaps a half-billion dollars; and all that expansion has been the result of profits slowly turned back into the business. In this respect the history of the Baldwin Locomotive Works is closely similar.

198. *Objections to this method.*—Yet in spite of these great successes we must not overlook the two obvious disadvantages of this method of obtaining funds for betterments. The first and most vital objection is that the slowness of the process may occasion the loss of valuable opportunities. While an old, conservative company is thus gradually acquiring the funds necessary for the expansion of its business, it may well be that a somewhat more daring concern may borrow the funds necessary for expansion and thus capture the opportunity that was at first open to both of them. Conservatism undoubtedly is a business virtue; yet for the best results it needs to be mixed with a strong dash of speculative fervor. The second objection is that the ordinary stockholder in any concern desires to enjoy the profits of a business as they are earned and objects strongly to having those profits diverted to betterment expenses. It is true that an increase in the corporation's assets is an increase in his assets, for he is part owner of the corporation. It is true, also, that an increase in assets will be to some extent reflected in a rise in the market value of his stock, so that he may sell out if he chooses and put his money into a more liberal corporation. This last, however, is not a wholly satisfactory argument to the stockholder, for market values are based more largely on earnings and dividends than they are on underlying assets. This is a truth that will be found fully illustrated in the volume on INVESTMENT AND SPECULATION. Thus the body of stockholders is apt to oppose strenuously a reduction in their dividends in order to provide for betterments. It seems to them as if they were being compelled to make a sacrifice for the benefit of future stockholders.

199. *The attitude of stockholders.*—An example

that was conspicuous a few years ago was the determined struggle on the part of minority stockholders in the Wells-Fargo Express Company for larger dividends. This company was controlled by the Harriman party, and Mr. E. H. Harriman, following his usual policy, was, as it seemed, too much inclined to sacrifice dividends to financial strength. The minority stockholders stated that the Wells-Fargo Company had been piling up an enormous surplus, which was not needed or used in the business, but was invested in the securities of other companies. The majority stockholders—that is the Harriman party—rejoined that the security holdings of the Wells-Fargo Company were for the sake of control and for the prevention of ruinous competition; in other words, that earnings had been consistently devoted to betterments. The undeniable facts are that the company was highly prosperous, was paying relatively small dividends and was more or less harassed by a body of dissatisfied stockholders.

The objections by the stockholders in such cases may be induced by any or all of three motives:

(1) They may simply be anxious for present dividends, even though they be paid at the risk of reducing the corporation's future earnings and prosperity. Human nature is so constituted that to almost all of us \$1 this year looks better than \$2 five years from now.

(2) Some of the stockholders may have speculative tendencies which lead them to desire a good market price and a quick sale for their stock—perhaps with the idea that after a while the dividends will be cut and they will be able to repurchase stock at much lower prices. This motive will always be strong when many of the stockholders belong to the speculating, rather than to the investing class. Here is one of the best reasons

why a conservative corporation manager will desire to put his stocks on an investment basis from the very beginning, if possible.

(3) The stockholders in a corporation which has a large funded debt may reason that whatever sums are diverted from dividends to betterments go to increase the security and the value of the corporation's bonds rather than of its stock. We shall have occasion to deal with this motive and its results when we take up in Chapter XXVIII the methods of manipulation for the benefit of the body of stockholders. It is enough to say here that this motive, although narrowly selfish, is still entirely legitimate and often has great weight.

Wherever these motives are at work—and some or all of them are likely to be strong in almost any body of stockholders—objections to heavy betterment expenditures out of earnings will be in evidence.

In the Wells-Fargo case the protesting stockholders however disagreeable they might make themselves, did not have much influence with the management, because they were distinctly in the minority. It often happens, however, that the active managers of a corporation are more prudent or more farsighted than the majority of their stockholders and for the good of the corporation desire to pursue a policy of small dividends and large betterment expenses which would not be supported if it were clearly presented to the stockholders. In order to attain their object the corporation officers must keep the stockholders more or less in the dark; and this they do by the very simple process of charging expenditures for betterments under operating expenses.

200. *The case of the Lehigh Valley Railroad.*—The history of the Lehigh Valley Railroad so well illustrates the workings and the results of this species of well-inten-

tioned deceit that it is worth a rapid review. In the year 1897 new interests, which were represented in the active management by President Walters, came into control of this company. The five years following, 1898 to 1902 inclusive, were a period of remarkable development and prosperity for almost all the railroads and industrial corporations of the United States, and the Lehigh Valley was no exception. Gross earnings from operation increased 25 per cent; the revenue tonnage increased 150 per cent; at the same time the average freight rate per ton per mile showed a slight gain. On the other hand, the outlay per train mile for moving this tonnage decreased. Thus earnings were apparently going up while running expenses relatively were decreasing, and a largely increased net income would naturally have been expected to follow. The facts were, however, that the gross income (not gross earnings) decreased from $6,800,000 in 1898 to $4,800,000 in 1901 and $4,650,000 in 1902, when the anthracite coal strike was in progress.

An inquiring stockholder, who might have chanced to consider with care these strange and anomalous figures, would perhaps have turned to the balance sheet of the company in the expectation of finding therein revealed some noteworthy addition to assets purchased out of earnings. But our inquiring friend would have been disappointed. He would have found the comparative figures of the important assets of the road as follows:

ASSETS

	1898	1902
Cost of Road	$18,689,291.95	$18,689,291.95
Cost of Equipment	19,018,419.98	19,018,419.98
Securities owned	32,949,822.14	39,300,209.80

The only change here is an increase in the securities owned, which is not sufficient in amount to account for all that apparently should have been saved out of earnings. The book values of road and equipment, it will be noticed, have not been changed.

The true explanation could have been found only by analysis of the operating expenses of the railroad. In the first place, the proportion of total operating expenses to gross earnings from operations—or operating ratio, as it is called—had risen from 70 per cent in 1898 to 81 per cent in 1902. As a normal railroad operating ratio would be 60 to 65 per cent, it is evident that this extraordinarily high ratio of the Lehigh Valley in 1902 indicated one of two things: either bad management or inflated operating expenses. We may get some light as to which was responsible in the present case by a slight further analysis of operating expenses. In 1895 22 5-10 per cent of the total operating expense went to maintenance of way; in 1902 over 40 per cent. In 1895 the average train-load was 384 tons; in 1902, 467 tons. Evidently large sums had been devoted during the interim to betterments which greatly increased the economy and efficiency of the road's management. We are now informed that during the five years, 1898 to 1902, all new equipment, all side-tracking and other expansions of track, all construction of bridges and buildings, all reballasting of track and similar items had been charged to operating expenses. Professor Edward Sherwood Meade, to whose searching analysis we are indebted for much of the information here presented, estimates that in these five years the Lehigh Valley under Mr. Walters' management, spent almost $13,000,000 on betterment expenses which ordinarily would have been provided for by new issues of stock or

bonds; in other words, the $13,000,000 under a different management would have been distributed to stockholders.

In 1902 a new management came into power, and the report for the fiscal year 1903 shows some radical changes in accounting methods. Net income, for instance, which had been $4,650,000 the preceding year, suddenly jumped to $8,300,000. The new management, after appropriating $1,250,000 for betterments and after paying all fixed charges, was still able to show over $2,000,000 available for dividends; this, in the face of a defiicit after allowing for fixed charges the preceding year of over $1,200,000. In 1904 the stock was given a dividend of 1 per cent. In 1905 it was put on a 4 per cent basis. Between 1901 and 1908 the gross earnings of the Lehigh Valley were increased about 33 per cent. Its net earnings were considerably more than doubled, and yet its fixed charges were increased scarcely at all. The figures below tell the whole story of this remarkable growth more plainly than it could be put in words:

	1908	*1901*	*Increase*
Miles operated.......	1,447	1,382	65
Gross earnings.......	$35,510,154	$26,683,533	$8,826,621
Gross, per mile......	24,500	19,300	5,200
Net earnings	12,183,582	5,765,113	6,418,469
Net, per mile	8,420	4,170	4,250
Chgs, less other inc...	4,813,008	4,364,800	448,208
Charges, per mile....	3,320	3,150	170
Surplus	7,370,574	1,400,313	5,970,261
Surplus, per mile.....	5,100	1,013	4,087

Now, what is the meaning of these facts and figures? In the first place, it is plain that the road was in poor

condition prior to Mr. Walters' administration and that he left it in such excellent condition that its net earnings afterward showed a phenomenal increase. There can be no question but that the millions which Mr. Walters poured into the property were wisely spent and have since been efficiently administered. To an investor or corporation manager this review should be an inspiring story of honest profits ably secured.

Nevertheless, it must be admitted that Mr. Walters' policy, so far as the stockholders were concerned, was one of evasion and deceit. True it is that whatever he did was intended for their own best interests; yet it is also true that they would not always have approved of his actions if they had known exactly what was going on. We do not need to enter into the ethics of the case. It is plain, however, that the stockholders, from any or all of the motives we have previously mentioned, might with justice have objected to Mr. Walters' course. As a matter of fact, they did finally become alive to the situation and helped in bringing a new management into power.

201. *Policy of the Union Bag and Paper Company.* —Another illustration of large operating expenses being used to beguile stockholders into putting a large portion of earnings into betterments is to be found in the recent history of one of the smaller trusts, the Union Bag and Paper Company. In a review of this company's condition, recently issued, we find the following remarks:

Benefit is now being derived from the liberality with which outlays for repair work, maintenance and improvements have been made. Since the formation of the company nine years ago, about $8,000,000 have been expended in construction, purchase of woodlands, etc., in addition to requirements for ordinary re-

pairs and maintenance which have been charged directly to operating expenses, and also in addition to the amounts expended in 1906 for the property of the Gres Falls Company and that of the Allen Bros. Company. All told over $6,000,000 have been expended, since the company's incorporation, for additional property and new construction, and the company has increased its capital obligations only to the extent of $2,439,000. While the company's physical and producing capacity has been undergoing improvement, its financial position has also been bettered, net working capital having been increased in the past four years by approximately $1,058,000 or about 100 per cent.

202. *Borrowing funds for betterments.*—The third means of raising funds for betterments is through issues of medium-term notes. It is not necessary to consider this method with great care, inasmuch as it has already been discussed in Chapter VIII. The examples given there were sufficient to show the dangers of this method. Obviously it cannot properly be utilized except to provide for betterments which are practically certain to yield large and immediate profits; otherwise the corporation will be incurring obligations that must be met out of income and that will perhaps become exceedingly dangerous.

A much better method, generally speaking, of securing the funds for permanent betterments is by means of long-term bonds. As has been previously explained, large well-established corporations do not usually expect to pay off these bonds when they fall due, but plan to refund them by new issues. In other words, what they actually do is to incur a permanent fixed charge. Now if a betterment is of such a character that it is practically certain to produce profits year after year larger than the fixed charges assumed in order to make the better-

ment, it is no doubt good policy to raise the necessary funds by the issue of long-time obligations.

203. *Policy of the Pennsylvania Railroad.*—The settled policy of the Pennsylvania Railroad is the best known and most consistent illustration of the working of this principle. This company, it is understood, separates all its betterment expenses into the two classes previously named: First, those which will in all human probability result in a permanent saving or profit more than equal to interest on the funds thus invested; second, those which will probably prove profitable, but which may or may not yield profits in the immediate future. To the first group the Pennsylvania management assigns such betterments as shortening and straightening a line, cutting down grades, providing new equipment where an increase in traffic is certain, and so on; to the second class they assign such betterments as a large part of the tunnel construction in and around New York City, providing new equipment for a hoped-for increase in traffic, operating passenger stations, and so on. The Pennsylvania Railroad's custom is to pay for all betterments of the first class by bond issues and for all betterments of the second class by appropriations from surplus. Thus the stockholders secure at the same time the maximum of returns and the maximum of safety. It is the ideal policy as regards betterments and will no doubt be more generally adopted in the future by railroad and industrial corporations.

To illustrate its workings in the concrete case of the tunnel into New York City and accompanying improvements, the following figures are presented. Up to the end of 1908 the total cost of the tunnel extension, as shown by the annual reports, was $77,528,664, of which only 60 per cent had been capitalized. The total cost

is covered by the following charges on the books and appropriations of surplus profits:

Cost on Books, December 31, 1908	$46,528,664
Charged to surplus income of 1908	1,000,000
Charged to profit and loss account in 1907	7,000,000
Charged to profit and loss account in 1906	13,000,000
Charged to profit and loss account in 1905	5,000,000
Charged to profit and loss account in 1903	5,000,000
Total cost of tunnel extension at end of 1908	$77,528,664

The cost on the books given above is the figure at which the Pennsylvania Railroad carried the work then accomplished as an asset. But in 1908 the Pennsylvania Railroad proper required the lines west of Pittsburg to assume a part of the burden and accordingly the Pennsylvania Company turned over $10,000,000 in securities, deducting the value thereof from its profit and loss surplus. Assuming that the income derived from these securities will defray the interest charges on $10,000,000 of the capital invested in the tunnel, the Pennsylvania Railroad will have to look to the operation of that property to yield fixed charges upon capital borrowings for that purpose of only about $36,500,000.

204. *General conclusions as to the financing of betterments.*—The only remaining method to consider of securing funds for betterments is by means of stock issues. The comparative merits of increasing capitalization by means of stock, as compared with bond, issues are too obvious to need much discussion. A bond issue is a cheaper means of getting the necessary funds, for bonds can always be sold to better advantage than stock which yields the same return; on the other hand, bond issues

are objectionable in so far as they tend to increase the fixed charges and thereby imperil the safety of the company. New stock issues are safe enough, but of course tend to reduce the rate of distribution on the stock already outstanding. We may, perhaps, lay down this general rule, that betterments of the second class—following the classification we have given—ought to be financed either out of surplus or by means of new stock issues; betterments of the first class ought to be financed by bond issues, or in rare cases by issues of medium-term notes.

In what is said with regard to the financing of betterments, as in all other general questions of corporation policy, we must be content with broad conclusions. Corporation managers who differ from the general principles here laid down are not necessarily to be condemned offhand. They may have good reasons which do not appear on the surface. Every business man must base has actions, not so much on general principles, as on the important concrete factors that confront him. At the same time it is also true that a clear understanding of these principles and of the practice of large corporations will aid the corporation manager in handling more intelligently and more successfully whatever peculiar and difficult problems arise before him.

CHAPTER XXIV

CREATION AND USE OF A SURPLUS

205. *Definition.*—One of the most talked about topics in the field of Corporation Finance is the "surplus," its formation and its management. Yet in spite of all the discussion, there is still a great deal of confusion even in the minds of lawyers and men familiar with financial affairs as to what a surplus is and what it is good for. The main principles that govern the management of surplus are not different from those which should control the management of other capital funds, and are simple enough to seem obvious when they are once clearly stated. That they are not always clearly comprehended, however, is proved by the loose writing and thinking with regard to the subject that is so often manifest.

A brief satisfactory definition of surplus is that it is the difference between the assets and the obligations of a corporation, including under "obligations" all the outstanding stock of the corporation, as well as its reserves and debts. Suppose, for instance, that we have a corporation with assets of all kinds, having a total book valuation of $1,000,000, and having on the other side of the account debts represented by accounts payable, bank loans, notes and bonds of $500,000, depreciation and other reserves of $50,000 and outstanding capital stock amounting to $250,000; it is evident that the corporation must have secured $200,000 of its assets from some other source within the business; and that

source we call surplus. The surplus account, as is explained in the volume of ACCOUNTING PRACTICE, appears on the liability side of the balance sheet, because it is an amount for which the corporation must render an account.

206. *Four sources of surplus.*—In our discussion of the corporation's surplus, we will consider:

(a) How it is obtained.
(b) What is done with it.
(c) Its uses and management.

One possible, though very unusual, means by which a corporation obtains a surplus is by inheritance. Take, for instance, a corporation which is a consolidation of two companies, each having a surplus of its own. The consolidation may conceivably simply guarantee the bonds and other outstanding debts of the subsidiary companies, may issue dollar for dollar in stock for the stock of the subsidiary companies and may transfer the former surpluses bodily to its own accounts. As we have seen in our study of the formation of consolidations, however, (Chapter XIV), the new corporation will usually issue securities far in excess of the market value of the assets of the old companies. The consolidation, therefore, will not only not start out with a surplus usually, but will be compelled greatly to overvalue its assets in order to make a balance sheet possible. We may dismiss this first possible source of surplus, then, with the statement that it is too uncommon to be worth discussion.

The second source of surplus, which also is rather unusual, is the selling of the corporate stock or bonds above par. Evidently the corporation in such a case receives a sum of money greater in amount than the obligations which it incurs. Now this extra sum may

be handled by an accountant in three or four different ways. One way is to include it in the corporation's surplus account. The propriety of this method may be disputed, but this is an accounting rather than a financial question.

A surplus may originate, in the third place, in whole or in part from the sale of a corporation's fixed or semifixed assets. Thus if a manufacturing company owns a plant which has become obsolete and worthless for manufacturing purposes, and the value of which has been fully covered by a depreciation reserve—in other words, written off the books—and afterwards sells this plant, the sum resulting would go into the surplus account. Of course, the reader will understand that if the value of the plant in such a case had not been written off the books, but was still included in the corporation's balance sheet, the only effect of its sale would be a transfer of the amount received from the property account to cash or notes receivable or whatever was taken in payment for the plant.

A similar source of surplus is a revaluation of the fixed assets of a corporation when the revaluation shows an increase in their value. This increase would naturally be represented on the liability side of the balance sheet by a corresponding gain in the surplus. Generally speaking—and it must be remembered that there are some exceptions to this rule—an upward revaluation of assets is not in accordance with correct accounting or financial principles. Therefore, this fourth source of surplus is not commonly found.

207. *The fifth source—saving.*—This brings us to the fifth and most common source of surplus, namely, saving from income. The uses to which income should be put have been discussed at some length in Chapter

XXI; and the final uses, after the fixed charges and reserves had been provided for, were found to be dividends and surplus. It will do no harm to reiterate the important principle there laid down that the dividends of practically every corporation should be maintained at a fixed rate and should move only to increase. Fluctuating dividends destroy the confidence of the investing public and greatly reduce the credit of the corporation below what it might possess. The proper policy, with few exceptions, is to ascertain the minimum net earnings of a company in the years of greatest depreciation and rigidly hold the dividends at or below that minimum. The rest of the net earnings will be transferred to the company's surplus account.

That this method of forming a surplus may build it up with great rapidity is shown by the record of that great industrial concern, the Standard Oil Company. The annual net profits, the sums appropriated to surplus and to dividends, and the totals of each item for seven years are as follows:

Year	*Profits*	*Dividends*	*Surplus after divs.*
1908	$ 80,000,000*	$39,335,320	$40,664,680*
1907	85,000,000*	39,335,320	45,664,680*
1906	83,122,251	39,335,320	43,786,931
1905	57,459,356	39,335,320	18,124,036
1904	61,670,110	35,188,266	26,481,844
1903	81,336,994	42,877,478	38,459,516
1902	64,613,363	43,851,956	20,761,407
Total	$513,202,074	$279,258,980	$233,943,094

*Approximated; not reported after 1906.

It is evident that in the case of any company which follows the principle just laid down, the proportion of dividends paid will vary with the fluctuations in earn-

ings. The greater those fluctuations the more rapid will be the increase in surplus. The converse proposition is that a stable rate of earnings makes unnecessary the creation of a big surplus.

208. *Policy of the "trusts,"*—Professor Edward S. Meade's well-known volume on "Trust Finance" gives the result of a careful study of the dividend and surplus policy at the beginning and during the existence of all our important industrial combinations or "trusts." The prime object of the managers of almost all these combinations at the beginning, Professor Meade points out, was to pay dividends and thereby encourage the sale of stock. They were therefore averse, as a rule, to appropriating any considerable amounts to the surplus account. They even, in some cases, incurred a deficit in order to pay dividends. Professor Meade computes that twenty-six important consolidations, which he has studied with especial care, earned in the four years 1898-1901, $150,201,390. He says:

> This amount, although large in the aggregate, represents but little more than 8 per cent per annum. It would appear, as already stated, that every consideration of prudence would incline the directors of these companies to reserve practically all their profits in order to strengthen the financial position of their companies. So far from following the path of prudence, however, 61.9 per cent—almost two-thirds of these profits—were paid out in dividends, leaving 38.1 per cent for the surplus reserve. The inadequacy of this reserve may be better understood when it is compared with the outstanding capital whose permanent value it was intended to secure. A reserve of only 4.2 per cent is the net result of the operations of three years.

The industrial trusts are excellent examples of corporations which for reasons of their own were reluctant

to keep dividends down to a conservative basis and to create large surpluses. The results of their imprudence are familiar to most of us—perhaps entirely too familiar to some. The common and preferred stock of most of these companies received dividends for a few years, but at the first hint of trade and financial depression, earnings fell off, dividends were stopped and the market prices of the stocks dropped with a thud. We have here presented an impressive lesson that ought to be mastered by every corporation director and stockholder—the lesson that in times of plenty provision should be made, through creation of an adequate surplus account out of income, for the seasons of famine that are sure to come.

209. *How should surplus be invested.*—We have next to consider what form the surplus of a corporation should take, or, in other words, how it should be invested. Its possible forms or uses are as numerous as the uses to which the original capital funds of a corporation may be put, and may be classified under the following heads:

(a) Cash.

(b) Securities.

(c) Decrease of current liabilities.

(d) Sinking fund.

(e) Increase in stock of raw materials or finished products on hand.

(f) Betterments.

(g) Extensions and additions to fixed assets.

It goes without saying that the surplus should be used to strengthen the weak spots, whatever they may be, in the corporation's capital equipment. We can be somewhat more specific, however.

210. *The surplus as a "rainy day fund."*—There are two distinct and opposed opinions as to the true function

of a surplus; one, that it should be merged with the rest of the corporation's capital funds; the other, that it should be set aside as an insurance against future losses. Let us first consider the justification and the results of this second opinion. Its advocates base their case on the assertion that the original investment of capital funds should be sufficient to carry on properly all the business of the company; if these funds are not sufficient, then they should be increased by borrowing or by bringing in new stockholders, not by saving out of profits. The arguments in favor of providing funds for betterment by borrowing, rather than by saving, have already been given and have been found to have considerable weight. The advocates of this opinion are convinced of the advisability of maintaining dividends at a stable rate and conceive it to be the true function of a surplus account to equalize the dividends over a series of years. In other words, the surplus account should be, in their view, as it has well been called, simply a "rainy day fund," to be drawn upon for dividends whenever the necessity arises.

It follows, if this opinion is correct, that the surplus ought to take the form of cash or something that may readily be turned into cash, for example, securities. Otherwise, it will not be readily available for dividends in periods of financial stress when it is most likely to be needed. It is true, to be sure, that a surplus may be invested in permanent assets and yet be treated as a "rainy day fund," for these assets may be made the basis of temporary loans to the corporation. The objection here is that it is uncertain whether such loans can be obtained when they are most needed and, moreover, it is unsafe to base temporary loans on a corporation's fixed assets. On the whole, then, we may say, that if the surplus ac-

count is to be regarded simply as a kind of reservoir in which future dividends for lean years are to be stored, that reservoir should be filled with cash or easily marketable securities.

The chief exponents of this policy are the great English and German shipping companies, particularly the Cunard Company and the Hamburg-American Line. The former company is said to have nearly one-third of its total assets invested in securities which have no direct connection with its shipping business. If the company runs into a period of intense competition during which it cannot earn dividends, or should it sustain severe losses, enough securities would be sold to maintain the regular dividend rate. There are obvious advantages in this course; on the other hand, there are disadvantages equally obvious and for most corporations of controlling importance.

The first disadvantage is that to build up a cash surplus is almost a waste of that much capital. It is a waste because capital in that form earns next to nothing. If it is kept as a permanent cash balance it may, to be sure, draw interest at 2 or 3 per cent, or in exceptional cases, even 3½ per cent; but this is a totally inadequate return on an industrial investment. If the surplus is in the form of marketable securities the case is almost as bad; for the only securities that are marketable in times of stringency are high grade bonds which do not yield above taxes more than 3½ per cent or 4 per cent at the outside. As the second disadvantage, it must be borne in mind in this connection that funds so invested, though safe enough from the corporation's standpoint, do not give the corporation stockholder safety sufficient to compensate for the small yield. What is meant by this statement is that the surplus, however invested, is

part of the corporation's capital and would be swallowed up by the corporation's creditors in case of bankruptcy. Thus the surplus goes to protect the creditor rather than the stockholder. The stockholder would be much better off, so far as safety is concerned, if his portion of the surplus were turned over to him individually and he would himself buy good securities with the proceeds.

211. *Putting the surplus back into the property.*—Having these disadvantages in view, corporation managers in this country have almost universally put the surplus of their corporations back into the property. Sometimes it is used to increase the cash balance where more cash is really needed in the business, or to buy securities of companies which it is desirable to control. In both these cases, however, the object is not to separate the surplus from the business, as it is when the rainy day fund is formed, but to make it productive in the business. Sometimes it goes into betterments, as explained in the previous chapter, or into extensions or into some other of the seven forms mentioned above. Just which form shall be chosen by the corporation management depends on considerations which have already been discussed in the chapter on "Investment of Capital Funds." As a normal return on capital invested in commercial enterprises in this country would run from 6 per cent on up, it is evident that as a rule the investment of surplus in the business in which it was produced is the best and most profitable policy.

Perhaps the stockholder may object at this point that the surplus is taken from the profits which ought to be turned over to him. The objection is superficial and fails to take into account the various methods by which a surplus may be, and in the end, must be, distributed to the corporation stockholders. Some of these methods

are not well understood; indeed it is doubtful whether half the stockholders in business corporations realize how or when their surplus is distributed to them. This is the interesting topic which will be the subject of our next chapter.

CHAPTER XXV

DISTRIBUTION OF THE SURPLUS

212. *Effect of a surplus on assets and dividends.*—Ordinarily, as stated in the preceding chapter, a surplus is formed out of savings from income and is invested in the capital assets of the corporation. Thus it becomes merged at once with the capital funds. The average stockholder feels that it is lost to him. He sees, to be sure, that the assets of the corporation are increased by the formation of a surplus, and he will admit probably, if you press him, that theoretically this increase in assets is a good thing for the corporation and for every stockholder and tends to increase the value of his stock. The admission, however, is apt to be grudgingly made and probably does not disturb the stockholder's conviction that whatever sums are devoted to surplus are taken out of the pockets of the owners of the corporation. He sees how these sums are taken away from him, but does not see clearly in what form they come back to him. The object of this chapter is to explain the methods by which the surplus may be and generally is returned.

It has already been mentioned—and, for that matter, is self-evident—that surplus wisely invested in capital assets increases the earning power of the corporation and therefore its ability to pay large dividends. Moreover, the surplus when properly invested so as to extend the sales of the corporation or its ownings of raw materials, or its control over competitive plants, tends strongly to make earnings more stable, and therefore to make prac-

ticable a distribution in dividends of a larger proportion of earnings. This is a point not often alluded to and worth a word of explanation. It is evident that generally speaking the larger the business a concern does, the more stable and dependable will be its earnings—for slight local fluctuations up and down will almost always balance each other. If a big jobbing corporation loses trade for local reasons in one section of the country, it may reasonably hope that gains in other sections will at least counterbalance the loss. It is also true that control, even partial control, over the prices of raw materials or of unfinished products tends to make earnings more stable. It may well happen for these reasons that a relatively small surplus will have a more than proportionate influence on a corporation dividend rate—not so much, to reiterate, because it increases earnings, as because it makes them more uniform.

Frequently—and this is especially true of a close corporation—no individual stockholder would be able to save and invest to such good advantage as the corporation can do for him. Take once more the famous example of the Carnegie Steel Company. Does anyone suppose that any single stockholder in that company would have become as wealthy if the earnings had regularly been paid out to the stockholders in dividends instead of being put back year after year into the property? The stockholders did not receive very large dividends for many years, and some perhaps were inclined to complain that they were not getting the returns on their investment that were justly due them. In this case the stockholders were never given any considerable proportion of earnings, nor was the vast surplus of the company distributed, except to a limited extent, until the sale of the Carnegie Steel Company in 1901 to the

United States Steel Corporation. Then the extraordinary strength and riches of the company were suddenly revealed. Almost a half-billion dollars in cash or salable securities were showered upon the fortunate stockholders of the company. Pittsburg, like a night-blooming cereus, suddenly blossomed with millionaires.

213. *Distribution through stock watering.*—This chapter is not to deal, however, with the distribution of surplus through its effect on dividends or through the final sale of the company's assets, but rather with the more direct and usual methods. First among these methods to be mentioned is the declaration of an extra stock dividend. In the year 1880 the Chicago, Rock Island and Pacific Railroad Company was a highly successful corporation with large earning power, due in part to the fact that for many years a considerable proportion of the earnings had been put back into the property. The directors of the corporation thought it wise to increase their dividend payments, and yet on account of the popular prejudice against large railroad earnings did not wish to increase the dividend rate. They therefore adopted the plan of consolidating with themselves a small subsidiary railroad, the stock of which they already owned; they paid for that stock and for the stock of the Chicago, Rock Island and Pacific Railroad Company by an immense issue of stock of an entirely new corporation, the Chicago, Rock Island and Pacific Railway Company. This stock of the new corporation was distributed to the old stockholders in the proportion of two new shares to one old share. Then on all the stock outstanding they declared and maintained a dividend rate nearly equal to what had previously been paid. In effect this process was a capitalization of a surplus of the corporation and a distribution

of the surplus to stockholders. A more recent instance of somewhat the same kind is the well-known Chicago and Alton deal, which is discussed in Chapter XXVII.

The essential feature of such a transaction is the capitalization of surplus and distribution of this extra capitalization to stockholders. The reader may inquire as to the advantage of this course. Surely, he will say, two shares of a total capital stock of $2,000,000 are worth no more than one share of a total capital stock of $1,000,000. The two shares in the first instance represent no larger proportion of assets and earnings than the one share in the second instance. This reasoning is plausible and true so far as it goes; yet the fact remains that the stockholders gain something by a stock dividend. In the first place, the dividend rate is kept down by this means, and in the case of public service corporations public hostility is to some extent avoided. In other words, the stock is watered, and the dividend rate maintained. The American Telephone and Telegraph Company is one of the many examples of companies which have thus greatly increased their capitalization from time to time, apparently with this object in view. A discussion of the ethics of such a transaction would be interesting, but is outside the scope of this volume.

In the second place, it is well known to corporation managers and to all who have studied the stock market with any care that two shares of stock, each paying 4 per cent per annum, will have a combined market price higher than one share of stock paying 8 per cent per annum. This seems a curious anomaly, but is readily explained. There are more people able and willing to buy low-priced than there are to buy high-priced securities. Therefore, the market for the two shares in this illustration is wider than the market for the one

share; that is to say, the demand for the two shares is somewhat greater and therefore their combined price will be higher.

This same principle leads the promoters of mining and oil and other highly speculative companies to fix the par value of their shares at a low figure, \$10 or \$1 or 10 cents, or even as low as 1 cent. Applying the principle to stock dividends we see that there may be a real gain to a stockholder in an increase in the number of shares he holds, even though there is no change in the amount of dividends he receives.

214. *Distribution through subscription privileges.*—We are ready now to discuss the most common and important method of distributing a surplus, namely, the granting of subscription privileges for new issues of stock. In most states, as the reader is already aware, stock cannot be regarded as fully paid if it is sold for less than its par value. No state, however, makes it obligatory under any circumstances to sell stock at more than its par value; yet the stocks of successful corporations which are able to maintain stable dividend rates of more than 6 to 7 per cent per annum, almost always have market values higher than par. Here is an opportunity for the corporation directors, if they see fit, to give the stockholders a valuable privilege—the privilege, namely, of buying new stock issues at less than the market prices.

The relative advantages of providing funds for improvements and extensions of property by bond issues, by stock issues and by appropriations from earnings, have been discussed in Chapter XXII. It was there laid down as a general principle that provision of permanent capital funds by means of stock issues is not advisable unless all the new stock is taken by the old stock-

holders. This condition will be fulfilled, however, when the old stockholders are given the valuable privilege of buying the new stock at less than its market value, and under such circumstances the raising of additional capital funds by stock issues is a very common and on the whole commendable method. We have now to consider exactly how surplus may be distributed by means of these "privileged subscriptions" and how each stockholder may best secure his share of the advantages that should accrue to him.

215. *An opportunity thus given for cheap investment.* —The privilege of buying a certain amount of stock below the market price enables the stockholder, if he chooses, to make a new investment on exceptionally favorable terms. For instance, in 1902 the Illinois Central Railroad Company put out a new stock issue and gave to its stockholders of record the privilege of buying the new stock at par in any amount up to 20 per cent of their stockholdings. Thus if a man had 100 shares of old stock, he was given an opportunity to buy 20 shares of the new stock at par. The average price of Illinois Central stock during the six months following the date of the new issue was 156½, thus showing a large paper profit to those who bought the new stock. As this stock was then paying an 8 per cent dividend, those who bought and held it for investment were getting much more than the usual market return on their investment.

A great many stockholders, however, do not care to increase their capital investment, but prefer to take their profits at once. In such a case they have a choice among four different methods of securing the profits, as follows:

(a) A stockholder may buy outright the proportion

of new stock allotted to him as a speculation, and a little later at some favorable opportunity may sell it.

(b) He may sell "short" after the issue of new stock is announced and deliver when he gets his quota of new stock.

(c) Instead of selling "short" he may sell outright an amount of his old holdings just equal to the amount of new stock that he has a right to buy.

(d) He may sell his privilege or "right" to subscribe to the new stock.

It will be well to compare briefly the advantages of these four methods.

216. *Cashing the privilege.—The subsequent sale.*—The first-named method is the simplest, but not generally the best. The chief difficulty is that the stockholder must pay cash for his quota of the new stock; and that means that he must either borrow the money or must lose the interest on some of his own funds. Frequently the subscriptions to the new stock are payable in installments. There may be a period of several months or a year between the date of the first installment and the final issue of the stock. For many stockholders it may prove decidedly inconvenient either to use their own funds or to borrow money. Another disadvantage lies in the well-known fact that the market price of any stock after a privileged subscription has been allotted to it almost always tends downward. One reason obviously is that the new issue increases by so much the total amount of stock outstanding; the second reason is that after a "right" has once been granted, investors figure that there will be no additional rights for a number of years; a third reason is that the chief men interested in a corporation that is about to put out a new issue and the underwriters of a new issue will usu-

ally "bull" the previously outstanding stock in advance, in order to create a good demand for the new issue. Now a stockholder who follows the first of the four methods and does not sell his stock until after he has paid for and received it, will probably sell on a falling market and will not reap as much profits as one who follows either of the other three methods. On the other hand, it must be said for this first method, that it is absolutely safe—a statement which cannot be applied to the method next to be considered."

217. *Cashing the privilege.—"Short selling."*—The mechanism of "short selling" has already been treated in Chapter XVII. In the case immediately before us a stockholder who had the right to subscribe to twenty shares of a new issue might deposit a margin of 10 to 15 per cent with his broker and instruct him to sell short. The broker borrows the twenty shares in order to make delivery and keeps on borrowing until the stockholder is able to get his twenty new shares from the corporation and turn them over to the broker to repay the borrowed stock. Under this arrangement the stockholder will be more likely than under the first method to get the top market price, because he will sell immediately after a "right" is announced—sometimes, if he has inside information, even before such announcement is made. This method further makes it unnecessary for the stockholder to borrow any money. He simply turns over his rights to his broker who uses, in order to pay for the new stock, the money that he has received from the "short" sale.

All this sounds very easy and simple and, as a matter of fact, it usually works out all right. The difficulty comes in the fact that any man who sells short runs the risk of being caught in a bull movement of that stock

or even in a "corner." [1] The reader may perhaps suggest that in such a case he may easily make delivery from his old stock and thus obviate any serious loss. The answer here, however, is that probably he has sold short the amount of his old stock as well as of his quota of new stock, or has in some other way tied up the old stock; otherwise, he would probably follow the third, rather than the second, method. Successful corners are not very common in Wall Street or any other market. When they do come, however, they bring disaster and ruin in their train.

218. *Cashing the privilege.—Sale of old stock.*—The third method is not open to either of the objections that have been specified. The stockholder is much more likely to get the best market price than under the first method; he is not involved in the dangers that attach to the second. He picks his own time to sell and from the proceeds of the sale has funds enough to buy the same amount of new stock with large profits in addition. The sale of part or all of the stockholder's shares will not impair in any way his right to subscribe to the new stock, inasmuch as this right is always granted to stockholders of record on a given day; it makes no difference whether the stockholder of record increases or decreases his holdings after that day. The only fault to be found with this method is that it is not practicable for all stockholders. A great many of them, in all probability, will have their holdings posted as collateral for loans, or for some other reason will not care to part with stock even temporarily.

219. *Cashing the privilege.—Sale of rights.*—The fourth method, the sale of "rights," is the next best plan

[1] The meaning of the term "corner" is explained in the volume on INVESTMENT AND SPECULATION.

ordinarily and is much used by those who do not care either to increase their holdings or to decrease them even temporarily. It is customary when any of the large corporations give their stockholders a "subscription privilege" to a new stock issue, to send out to each holder of record a formal statement of the number of new shares to which he has a right to subscribe. Such documents may be endorsed and transferred in the same way as stock certificates and are bought and sold on many of the stock exchanges and on the New York Curb Market. These documents are themselves known as "rights," just as certificates of stock are loosely called "stock."

As we stated in Chapter XVII, there are confusing differences of terminology between the New York and some of the other stock exchanges, particularly Philadelphia. In New York a "right" is the privilege to subscribe to a certain amount, usually a fractional part of a share of new stock. A stockholder, therefore, has as many "rights" as he has shares. In Philadelphia, on the other hand, a "right" means the privilege of buying one of the new shares of stock. To illustrate, suppose that the Lehigh Valley Railroad Company, whose securities are listed on both exchanges, should issue new stock to old stockholders at less than the market price and should give the subscription privilege at the rate of one new share to every five old shares. In that case the holder of five shares would have one "right" to dispose of on the Philadelphia or five "rights" on the New York Exchange. Of course the Philadelphia "right" would be worth five times as much as the New York "right." The difference is merely in terminology.

It may be thought that the third and fourth methods would yield practically the same returns, but this is an

error. The third method is almost always more profitable, the reason being that there is a much broader demand for stock than there is for "rights" to subscribe to stock. As was explained in Chapter XVII, there is a large body of purchasers not directly concerned with the stock market, who are constantly taking the standard stocks out of that market and holding them for permanent investment. This demand does not exist in the case of "rights," because few people, outside of those whose business it is to know such things, understand how the value of a "right" is figured or even what it is. It would often be greatly to the advantage of these permanent investors if they did buy "rights" instead of stock. As the matter now stands, however, almost the only buyers are stock brokers and their immediate followers who buy as a quick speculation in the hope of making a quick profit. As they are willing to buy only in case they think they are getting a bargain, it follows that the price of rights is usually less than it should be theoretically.

220. *Theoretical value of a right.*—Let us see how the value of a right should in theory be ascertained. The reader may perhaps have jumped at the conclusion that the value would be the difference between the market price of the old stock and the price at which the new stock is sold to stockholders. This is incorrect, however, because it fails to take into consideration the change in the value of each share brought about by an increase in the amount of stock outstanding. The new stock, it must be remembered, is issued at less than the market price, and does, not, therefore, bring to the company's treasury its proportionate amount of assets. For this reason it is inevitable that the market price of

each share after the new stock has been issued should be less than it was before.

To illustrate these abstract and rather vague statements, take the case previously cited, that of the Illinois Central Railroad, which in August, 1902, increased its stock 20 per cent and gave to each five shares of old stock the privilege of subscribing to one new share at par. The market price of the old stock at the time the rights were granted was about 170, giving a premium, or excess above par, of \$70 per share. Now there is to be added for each share of the old stock, \$20 in assets, because each old share has the right to subscribe to one-fifth of a new share at par. At the same time there is to be added \$20 to the capital stock for each \$100 previously outstanding. The market value of each share, therefore, after the new stock has been issued, will be $\frac{170 + 20}{100 + 20}$ = 158 2/6, which in theory would be the market price of each share after the new stock issue. As a matter of fact, the average price of Illinois Central shares during the six months following August, 1902, was 152 3-5. The value of the "right" belonging to each share of old stock would, of course, be in this case one-fifth of the difference between par and the market price of each share of new stock, or 1-5 of 58 1-3, approximately 11 2-3.

The following formula, commonly used on the New York Stock Exchange, gives directly the theoretical value of a right. Let P represent the premium on the old shares and R represent the percentage of increase. Then the value of a right will be found by the formula $\frac{P \times R}{1 + R}$. Applying this formula to the Illinois Central

example, we would have $\frac{70 \times .2}{1 + .2} = \frac{14}{1.2} = 11.66$. As has been stated these theoretical prices for "rights" are seldom obtained because speculative purchasers of rights are not willing to go that high. Moreover, there are some assumptions underlying these mathematical formulae which may or may not be true. It is assumed, for instance, that the stock market price of the old stock is a normal price uninfluenced by speculative factors. It is assumed, also, that the company's use of the funds which come to it from the sale of new stock will be neither more nor less remunerative than the use of the capital funds previously in its possession. It is assumed, moreover, that the market price after the new stock has been issued will be uninfluenced by speculative factors. There is a risk in all these assumptions, as the professional stock market trader well knows, and he is therefore unwilling to pay the full theoretical price for the rights.

Summing up, then, we may conclude that of the four methods of securing profits from privileged subscriptions, which have been described, the third method is, on the whole, likely to yield the largest returns. The second method comes next in that respect, but has the disadvantage of being dangerous. The fourth method comes next, and the first method is, on the whole, least desirable. It will not do to accept these conclusions as being true at all times and under all circumstances. They are merely generalizations based on experience.

221. *Privilege subscriptions as a method of stock watering.*—So far as distribution of surplus is concerned, giving "rights" to privileged subscriptions to new issues of stock produces the same effect, though not to an equal degree, as a stock dividend. The assets

of the company in proportion to the number of shares are diminished, and the stockholder gets the benefit. If the old rate of dividends is maintained on all the stock outstanding after the new issue, each stockholder may be truthfully said to have come into possession of some of the company's surplus. The privileged subscription is a device for increasing capitalization without proportionately increasing assets. In that sense it is "stock watering."

The meaning of the terms "stock watering" and "overcapitalization" have been sufficiently discussed and need not be given further attention. It is enough to reiterate that whatever may be said for or against the practice in connection with public service corporations, it is in private corporations, when properly used, a simple and legitimate means of making a corporation's capitalization correspond to its earning powers; and is in addition, as outlined in this chapter, a legitmate means of transferring to the stockholder a part of the surplus which his company has created for him.

CHAPTER XXVI

MANIPULATION BY CORPORATION OFFICERS

222. *Ought we to study manipulation?*—So far we have been dealing with and endeavoring to formulate the principles of honest and efficient corporate management; the rest of this book will deal with dishonesty, inefficiency and failure. Sometimes any study of rascality is condemned offhand on the ground that it may suggest swindling practices to persons who otherwise would not have thought of them. Perhaps there is something to be said in favor of this view; if any readers of this volume feel themselves morally weak it may be well for them to omit the next three chapters. On the other side of the argument, we may say that a thorough knowledge of fraudulent methods does not by any means encourage fraud, for it reveals that almost all such methods, however cunning they may appear, are unsound and dangerous. Furthermore—and this is the important point—honest men ought certainly to acquire as clear an insight as they can into the methods of swindlers in order that they may be on their guard and may protect themselves and those who are dependent upon them.

223. *The corporate form favors manipulation.*—The corporation, as practically every business man now appreciates, is for most concerns the most convenient, useful and efficient form of organization that has yet been devised. It is likewise true that the corporation so far has proved itself a most efficient form in the hands of

rascals for transferring other people's rightful property into their own pockets. In an address on "Abuse of Corporate Privileges" printed in the *American Law Review* Mr. Seymour D. Thompson has described from the lawyer's point of view the present conditions. He says:

Our corporate life is honeycombed with corruption. A corporation is formed; its business is put into the hands of certain managers holding some of its stock and expert in the management of its business. Debts are created and the managers become the creditors. The result is that rings are organized within rings, wheels within wheels, combinations within combinations. The managers, in the character of creditors, seize upon and foreclose the property of the corporation, and by well-known processes squeeze the other stockholders out and become themselves proprietors with larger holdings than they had before. This sweating process, dignified by the name of foreclosing and reorganizing, has come to be a regular industry in our courts of justice. Courts of justice have neither the time nor the means to take upon themselves the management of all the corporations in the country; and therefore the outraged and complaining stockholders are told that they cannot come into court until they have exhausted all the remedies within the corporation.

224. *Is manipulation a necessary evil?*—Now this deplorable condition, which is one of the chief evils of the American business world, is not, fortunately, a necessary evil. We may well doubt, indeed, whether the lawyers with their quibbles and conservatism will do much to remedy conditions. But we may expect much from the growing interest of the public in corporate affairs. The evil exists chiefly because the corporate form of organization is still a thing in which most people have had little experience and the workings of which they do not

clearly understand. The true remedy, then, for the evils of corporate manipulation, is publicity and education. These three chapters following, which constitute the first attempt, so far as the author knows, to classify and describe the methods commonly used for defrauding some of the owners of a corporation for the benefit of others, will fulfill their chief purpose if they have some slight influence in checking this evil.

Perhaps the words "fraud" and swindling" in the preceding paragraphs should not have been used; they do not convey exactly the conception which is in the author's mind in writing these chapters. We are not to be concerned here with ordinary clear cases of fraud; a study of such cases belongs to law rather than to finance. Moreover, a clear-cut instance of fraud is not usually a very dangerous thing, because the victim may seek and obtain redress in the courts. The chief danger comes not from crude and obviously illegal larceny, but from acts that cannot be proven fraudulent and that belong in the shadowy borderland, bounded by shrewd dealing on the one side and on the other by plain swindling. Some of the practices to be described are allowable, although most of them are discredited under the rules of the business game as those rules are generally interpreted.

225. *Scope of the chapters on manipulation.*—It should be made plain also at the beginning that in these chapters not much will be said about "malefactors of great wealth" or about large "predatory corporations," although some of these corporations furnish shining examples which cannot be overlooked. We shall deal rather with everyday small business corporations and with those kinds of manipulation that may be found in every section of the country. The "sharks" of Wall

Street do not by any means have a monopoly, as some of the cases to be cited will show, on dubious finance.

As a basis of classification we will take up methods of manipulation under the four heads:

(a) Manipulation by officials.
(b) Manipulation by directors
(c) Manipulation for stockholders as a body.
(d) Manipulation for controlling stockholders.

Of course, this classification is not exact. We shall find constant overlapping, for the obvious reason that any man or group who desire to manipulate will probably try to make their control as complete as possible, and will work through stockholders' meetings, directors' meetings, and officers' administration. Nevertheless, this classification will be found convenient and for the present purpose sufficiently accurate.

226. *Exorbitant salaries.*—The most obvious and common method by which a corporation official may milk a corporation of its profits is by paying himself an exorbitant salary. This is a practice so frequent and so easy that it would be superfluous to cite examples. A corporation official cannot, to be sure, absolutely fix his own salary, for that power is reserved to the directors. If the official, however, is a powerful stockholder, or if two or three officials can get hold of a majority of the stock, or if an official can bring outside pressure to bear upon the board of directors, he may cause a salary to be allotted to him far in excess of what he is actually worth to the company. It is not at all unusual for minority stockholders in small corporations to be deprived of profits because the president, or other official, who owns the controlling stock raises his own salary as fast as profits go up. It would be very difficult—practically impossible—in such a case to prove fraud. No

court would undertake to say that a salary was fraudulent, or that directors were acting beyond their powers in agreeing to it, unless the salary were beyond all reason.

227. *Fraudulent contracts.*—Another favorite method of manipulation by officers is the use, or rather abuse, of their power to purchase and to make contracts on behalf of the corporation. The evil of purchasing officers being in league with the firms from which they buy supplies and getting a rake-off on the corporation's purchases, has been so much exploited as to make unnecessary any further illustration. There is no question but that something of the kind does go on in many of the larger corporations. Yet the purchasing agent is generally a subordinate official whose policy is closely scrutinized by his superiors and who is subject to instant dismissal if any strong tendency on his part toward "grafting" is discovered. His delinquencies are not so interesting to in this study as those of his superiors. Let us examine briefly a few instances in which high corporate officials have misused their power to bind the corporation.

In the Illinois courts some years ago suit was brought by H. P. Killjoy, a stockholder, against the Mandarin Brewing Association. He alleged, and seems to have proved to the satisfaction of the court, that in 1896 three brothers purchased a majority of the stock and obtained control of this brewing corporation They elected themselves to the directorate and to most of the corporation offices One of the brothers owned a piece of real estate which the corporation purchased at an amount alleged to have been far in excess of its true value. The brothers, as directors, paid themselves large salaries as officers and no dividends were forthcoming

to the stockholders. The stockholders were kept in ignorance of the purchase of the real estate and of the size of the salaries. Although the court was so far convinced of the truth of these allegations that a receiver was appointed for the company, no criminal or civil action was taken against the three brothers.

The facts cited in a recent case in the Massachusetts courts are of interest in this connection. Samuelson, defendant in the case, was treasurer of the Easton Ferry Company. He sold bonds of the company and neglected to account for them. He charged the company for bank discounts larger than the bank charged, claiming that this extra discount was for his own personal indorsement, which appeared on the notes. He purchased coal in his own name at a low price and, as treasurer, bought the same coal for the company from himself at a high price. In this case the court ruled that Samuelson should be charged with the market value of the bonds that he had sold and should refund the difference between the market price of the coal and the price at which he had purchased it from himself for the company. Here again there was no hint of criminal liability or punishment.

Take another case, this time from the New York courts. Two officers of a paper company obtained an option to purchase a manufacturing plant for $75,000. The same plant was sold to the corporation, of which one of the defendants was president, for $100,000. The deed was taken directly from the owner of the plant to the corporation reciting a consideration of $1. The majority of the stockholders had no knowledge of the option price of $75,000 until later. On learning the facts they elected new officers who, on behalf of the company, brought suit against the defendants for the

difference between the true purchase price and the price charged to the corporation. The suit was unsuccessful.

As this is not a legal treatise, a discussion of the exact legal reasons for the decisions of the court in each of the three cases cited is not necessary here. The important feature common to the three cases and common to practically all similar cases is that in the present state of the law an official may make contracts and purchases directly advantageous to himself and disadvantageous to the corporation without fear of punishment—provided, of course, that he and his lawyers make no legal blunders. Assuming that he avoids this pitfall, the worst that can happen to him through the operation of the law is a restitution of his ill-gotten gains, which is, of course, no punishment at all. His true punishment comes simply in the fact that sooner or later his dishonesty will be discovered and his reputation among honorable business men will be indelibly smirched.

228. *New companies for profitable business.*—A third method by which corporation officials often transfer an undue portion of corporate profits to themselves is by the formation of new companies for profitable business. Every corporation, whether it be railroad, industrial, trading or financial, will find some features of its operations more profitable than others. The ordinary stockholder may not know anything about the actual operation of the business or about the opportunities for large profits; obviously the officers who do understand the situation are under a strong temptation to use their knowledge for their own, instead of for the corporation's, benefit.

The writer, for instance, knows of a company of considerable size, which is in the business of buying and sell-

ing domestic rugs and carpets. The concern began to deal in a small way in oriental rugs and Smith and Jones, the president and office manager, respectively, discovered at once that in their town this business was extraordinarily profitable. Instead of taking hold of the business and developing it for the established corporation of which they were officers, Jones resigned his position, organized a new company, in which Smith was secretly a large stockholder, and quickly secured all the oriental rug trade of their city for the new corporation. The stockholders of the first corporation retain Smith as their president to this day and regard him highly for his business ability. At the same time, Smith is growing rich from the profits of the new corporation. The stockholders, even if they know all the facts, would not be justified in saying that they had been defrauded. All that they have lost, in fact, is an opportunity. The ethics of the proposition is too big a question to be here discussed. Whether the action of the officials in this case be regarded as right or wrong, it is certainly true that its effect was to transfer possible profits from the corporation to the officers.

Take another instance, which has been related to the writer by a public accountant. The Automatic Door Fastening Company is a corporation with a large capitalization. It controls a patent device that can be cheaply manufactured and readily sold at a good price. The officers easily sold the stock to a number of small investors who were impressed with the high value of the patent and the large profits which would certainly be forthcoming as soon as it was put on the market. The corporation secured the necessary amount of capital funds, and manufactured the device; at this point the stockholders learned that a subsidiary corporation

owned by the officers, had been formed in each section of the country where sales were expected to be large and that every subsidiary corporation had a hard and fast contract with the parent company by which the subsidiary company got the device at a price that barely covered the cost of manufacture and was given exclusive selling rights in its own section. Practically all the profits evidently were thereby transferred from the corporation to the subsidiary companies. However the despatch lines have now been taken over by the railroad companies, so that there is no possibility of manipulation in the future.

There is nothing new in such an arrangement. Thirty-five years ago when the numerous short-distance railroads of the United States were first being consolidated into systems, railroad officials discovered that the most profitable traffic was that which moved over long distances. It was not long after this discovery before twenty-five or thirty "despatch lines" and "fast freight lines" were in existence, each of which handled the through long-distance traffic over two or more railroads under contracts by which much the greater portion of the large profits went to the despatch line companies. It is almost needless to add that the chief stockholders of these new companies were railroad officials.

The same principle was applied by Commodore Vanderbilt when the New York Central System was formed by holding in his own hands the stock of companies which owned the important terminals of the railroad. These terminals were then leased to the New York Central on terms that were not generally exorbitant, but that nevertheless yielded a large return to the Commodore. Although the Vanderbilt family for many years have not held a majority or anything like a

majority of the New York Central stock, yet they have been able to dominate the management of that road and to secure for themselves large profits through their ownership of these terminal companies.

229. *Misuse of inside information.* — The fourth method of milking a corporation for the benefit of its officers is by making use of "inside" information. This is, on the whole, the safest and least disreputable method. Indeed the line between the proper and improper use of the information that necessarily comes into the officers' possession is so indistinct that no one has yet been able to trace it. We are all agreed, no doubt, that it is quite improper for the president of a corporation to make a business of speculating in the stock of his company, specially if he "sells short" and thereby puts himself under temptation to mismanage the company. On the other hand, probably few people would raise any objection to an officer's investing in some shares of his company's stock, if he has good reason to believe that the stock is selling below its true value; nor does there seem to be any valid objection to his selling this same stock, if later he discovers that speculative forces have raised it far above its true value. Now just where shall the line between what is proper and improper in this regard be drawn? No one can say. It is as shadowy as the line between speculative and investment buying.

Whatever doubt there may be as to whether the use of inside information by a corporation officer to guide his buying and selling of stock is improper or not, there can certainly be no question but that the use of such information by an officer in order to enrich himself directly at the expense of the corporation is wholly un-

justifiable. The three cases cited below are fair examples of what is sometimes done:

(a) An officer of an oil refining company in Pennsylvania, who had no authority to sell stock for the corporation, received a buying order addressed to himself as an official of the corporation for 5,000 shares at 20 cents a share. He filled the order by transferring 5,000 shares from himself to the purchaser and then took for himself 5,000 shares of treasury stock at the special price of 2 cents a share. In this case, the facts being fully proved, the court ordered a refund of the difference between the two prices to the corporation.

(b) The XYZ Manufacturing Company, with capital stock of $500,000, one-half paid in, went into receivers' hands. The company had notes for $20,000 outstanding, bearing 10 per cent interest and secured by a mortgage on its property. The president, knowing the condition of the company, just before the failure, secured the notes in exchange for $30,000 face value of his stock in the company. Ten thousand dollars was paid on the notes when they fell due, but the other stockholders objected to paying the remainder. The president transferred his claim for the remaining $10,000 to an outsider and the court enforced payment of the claim.

(c) Robinson, the treasurer of a railroad company, which was in poor condition, bought up outstanding notes of the company at a large discount with his own money and as treasurer saw to it that the notes were paid when due at their full face value. The court held that the treasurer had done nothing illegal. He was at liberty to buy the notes for himself, as he was under no obligation to buy them for the road. He could meet them when due with the road's money, as that

money was there to pay any or all of the road's debts and not any special debt.

The striking feature of these three cases, as in several of the other cases cited, is that although the officials were obviously unfaithful to their trust and were not acting in good faith as agents for the corporation, they were nevertheless able to escape legal punishment.

230. *Is manipulation by officers common?*—The four methods that have been given and illustrated, by which corporations are frequently deprived of part of their just profits by their own officers are:

(a) Exorbitant salaries.

(b) Collusion or fraud in marketing, purchases and contracts.

(c) Formation of new companies for especially profitable business.

(d) Misuse of confidential information which comes to officers by virtue of their position.

It would certainly be a gross exaggeration to say that all or a majority of the corporation officers of the United States are guilty of any of these practices. On the contrary, it is probably true that their dealings with or for the corporation which they serve are in most cases absolutely honorable. Yet it must be regretfully admitted that these four methods of milking a corporation are only too well-known and too skillfully practiced. As an accountant of wide experience says, in speaking of corporate manipulation by officers, "That this is constantly being done is obvious from the fact that so many men, drawing salaries with large corporations, of $10,000 to $15,000 a year, become millionaires in a very short period. It is a mere matter of arithmetic to demonstrate that this is not done out of the money that they save."

231. *Canada fairly free from manipulation.*—Comparatively little is heard in Canada respecting manipulation by corporation directors. The chief complaint along that line seems to have been regarding the profits made by promoters of new companies and of industrial consolidations, which naturally has included directors. The investor, in future, will undoubtedly keep a sharp watch upon this opportunity for abuse.

The tendency in the Dominion is for corporations to employ reputable chartered accountants and appraisal companies to examine and report upon their financial position for the benefit of shareholders and prospective investors. This is a gratifying development.

With regard to dividend and other official announcements of corporations, Canada has been notably free from the premature divulgence of information. The secrecy with which such announcements as that of the Canadian Pacific Railway, for instance, are guarded, is noteworthy. Not a whisper is hea d in financial circles until the statements are issued from the directors' meeting or the office of the president.

Few cases have come to light wherein Canadian directors have benefited in stock operations by the receipt of "inside" information.

CHAPTER XXVII

MANIPULATION BY DIRECTORS

232. *Usual methods.*—As has already been stated, it is difficult to draw the line between manipulation by officers and manipulation by directors, for in most cases more or less collusion between the two is essential to the success of any of their fraudulent schemes. It is possible, however, to draw a distinction between those forms of manipulation which are primarily intended for the benefit of officers and those forms which are primarily for the benefit of directors; with the latter class of manipulative methods we have now to deal.

The method that was given the first place in our consideration of manipulation by officers, namely, exorbitant salaries, is not worth attention here. Directors, to be sure, are frequently allowed fees for attending meetings, and sometimes these fees seem to be somewhat excessive. They are frequently prescribed, however, in the by-laws, in which case, of course, the stockholders as a body would have no ground for complaint against the directors as a body. In any case, the fees are not large enough to make it worth while for the directors to attempt to defraud the stockholders and enrich themselves by this particular method. Without much question the courts would set aside directors' fees for attending meetings much higher than $10 to $25 for each meeting and would look with suspicion on an especially large number of meetings.

Eliminating this possible method of manipulation, then, as of small consequence, we may set down four important and not uncommon means of transferring an undue proportion of a company's assets and profits to the pockets of its directors. These four methods are:

(a) Fraudulent purchases and contracts.

(b) Formation of new companies for especially profitable business.

(c) Deceiving the body of stockholders by means of juggled accounts.

(d) Forcing the corporation unnecessarily into bankruptcy or into receivers' hands.

The reader will observe that the first two methods have been discussed in the preceding chapter. There are, however, some variations that should be mentioned between the application of these methods by officers and by directors.

233. *Fraudulent contracts.*—The number of cases of fraudulent purchases and contracts by directors that have been brought before the courts are so numerous that it is difficult to make a selection. The following instances are typical:

(a) In an Alabama case the facts brought out were as follows: The promoters of a large electric manufacturing company obtained as a profit in its formation approximately $2,000,000 of stock and were thereby able to exercise considerable influence on the board of directors. The directors, in spite of the demands of several stockholders, neglected to seek to recover from the promoters any portion of their excessive profit. Suit was brought by a stockholder to compel the directors to act and they replied that they deemed the proposed attempt to recover inexpedient. It is intimated in the court's decision that they were improperly influenced

by the promoters and the court ordered them to make the attempt.

(b) Three directors of a corporation formed to build a summer resort hotel caused the corporation to purchase the land on which the hotel was to be located from themselves at a 200 per cent profit to themselves. The land was purchased subject to a heavy mortgage. When only $25,000 had been subscribed toward the $90,000 required to erect the hotel, the directors made a contract to start construction of the building. Their object in so doing was to enhance the value of other land in that vicinity which they owned. The corporation became insolvent and the directors, on foreclosing their mortgage on the land, virtually became the owners of the land and of as much of the hotel building as had been erected. The court in this case held that the directors were liable to the stockholders for the depreciation in the market value of the stock.

(c) Two of three directors of a South Dakota corporation, for the purpose of securing control of the corporation for themselves, caused the issue and immediate sale to one of their friends of a large amount of new stock sufficient to give the two directors and their friend together a majority. The court held that as the friend knew all the facts, the sale of the stock conferred no rights upon the purchaser. It may be inferred from this decision that if the purchaser had been an innocent party, the transaction would have been valid.

(d) In a somewhat similar instance in New York a full board of directors authorized the issue of sixty-seven shares of stock to increase its capital. The president of the company reported at a subsequent meeting that he had received no subscriptions, and four of the

seven directors thereupon took the stock without knowledge of the holder of the majority of stock previously issued, who was also a director. In this case the court allowed the purchasers to hold and vote the stock, but enjoined them from using it to the injury of the previous majority holder.

(e) A railroad company was organized in Minnesota to build a local road in that state. Capital stock of $2,000,000 and bonds to the extent of $1,500,00 were authorized. A director and owner of a majority of the outstanding shares drew up a contract with the XYZ Construction Company under which the company was to build the road and receive 331 shares of its capital stock together with first mortgage bonds to the amount of $20,000 per mile. The XYZ Construction Company then made a contract on its own account with the firm of A & B, under which the firm was to pay $5,446 for each $20,000 block of bonds and in addition was to furnish the material necessary to build the road. The director above referred to was interested with A & B and was to receive for himself an agreed share of the railroad bonds. The actual cost of construction was to be about $14,000 a mile. The contract came before the board of directors and two directors, whom we shall call Smith and Jones, voted for the contract with the understanding that they also were to become interested with A & B and to receive a portion of the profits. Afterwards they offered to contribute one-fourth of the cash required for actual construction of the road in order to become partners with A & B. Their offer was refused. They then brought suit, exposed the whole transaction and asked to have the contracts declared void for fraud. The court held that there was no fraud on the face of the transaction but that

fraud could plainly be inferred, inasmuch as the corporation was made to pay more than was necessary for construction. They held, however, that the two directors, Smith and Jones, having knowledge of the transaction, did not come into court with "clean hands" and could not cry fraud because they lost what they had attempted to gain. The contract, therefore, was not set aside.

234. *Attitude of the courts.*—These illustrations, taken almost at random, indicate what opportunities for fraudulent manipulation are open to corporate directors and how slight is the danger of legal punishment. As may be observed over and over again, the courts assume that a corporation is honestly managed in accordance with the wishes of the stockholders unless the contrary is absolutely proved. Stockholders who object to the contracts and purchases made by their directors are apt to be told that their true remedy is to elect a new board.

Obviously this principle of the law, however far from applicable it may be in particular cases, works out, on the whole, for the good of the greatest number. Most corporations are honestly managed. Directors are rightly believed generally to have a far more extensive knowledge of the affairs of the corporation and of the contracts and purchases that should be made than the body of stockholders have. The courts, therefore, ordinarily do not desire to set aside contracts made by the directors or even by investigation to cast doubt upon those contracts. The attitude of the courts, it must be admitted, is correct. On the other hand, as the instances given above plainly indicate, it is also true that this attitude gives directors almost unlimited opportunities for fraudulent manipulation. The only

practicable remedy in the long run is for the stockholders to be exceedingly careful to elect men of proved probity to their directorate.

235. *New companies for profitable business.*—The second method of manipulation by directors that has been named is the formation of new companies for profitable business. A few typical illustrations will best explain the working of this method.

(a) The directors of a New York building and loan association, the charter of which required the funds to be invested in first mortgages, nevertheless bought some second mortgages. The association became insolvent and receivers were appointed. Some of the directors then organized a realty company which took from the receivers the land and buildings owned by the association at 50 cents on the dollar and made part payment with additional second mortgages. The directors thus secured for themselves at small cost most of the valuable assets of the association. The court discharged the receiver and appointed another receiver to conserve the remaining assets.

(b) The Strong Lumber Company and the Hoffman Manufacturing Company elected three men, constituting a majority of both boards, directors of both companies. The Hoffman Manufacturing Company, which had the better credit, accepted time drafts drawn upon it by the Strong Lumber Company, although no consideration had been given. To secure themselves from personal liability the three men as directors of the Strong Company placed a mortgage on the property of that company and issued bonds which were turned over to the Hoffman Company. When the facts were presented, the court entered a decree setting aside the mortgage.

(c) The directors of a railroad company in Nevada were members of a syndicate which intended to build a connecting road. The road was built and paid for by the syndicate and was mortgaged heavily. The syndicate received all the bonds and stock and then transferred 51 per cent of the stock to the railroad company, of which they were directors, in consideration of this company's guaranteeing the bonds. The guarantee of the bonds allowed the syndicate to sell them at a good price. The court held that allegations of fraud were not sustained and that the whole transaction was legitimate.

In the last two cases the profit to the directors evidently came in the form of increased credit for companies in which they were interested. It seems clear in both cases that there was no corresponding advantage to the corporation; otherwise the corporation in each case would have made the arrangement on its own account. The reader will observe, no doubt, that directors have opportunities of the same kind as those which fall to officers, when it is discovered that some particular feature of a company's business is especially profitable. Either the directors or the officers, or both together, may organize a new company of their own to handle that business and thus may divert profits to themselves.

236. *Juggling accounts.*—The third means open to directors, who wish to manipulate corporate affairs for their own interests, is to tamper with the corporation's books and thus give the stockholders a wrong impression as to the company's condition. The methods that may be used to accomplish this object are so numerous and so complicated that it would be impracticable to enumerate all of them here. Indeed, this section of our subject belongs to accounting rather than to finance. A few

typical instances, however, which have been supplied by some of the most experienced and best known public accountants in the United States to the writer, may be enumerated. The reader will find further light on this important subject in the volume on AUDITING.

(a) The directors of a holding company, which owned the entire stock of four separate manufacturing companies, desired to present a favorable report of the year's operations to their stockholders. In order to do so they took into account dividends paid by three of the companies and ignored altogether a very heavy loss incurred by the fourth company. Their excuse for so doing—which excuse, however, carries very little weight—was that the holding company as a stockholder in the other companies was entitled to the benefit of all the dividends declared, but could not be called upon to make up any loss that might be sustained; this excuse obviously overlooks the fact that the loss incurred by the fourth company constituted a diminution of the assets of the holding company. A firm of certified public accountants was called upon to sign the misleading report prepared by the directors. The accountants were given access to the books of the holding company but were refused the books of the subsidiary companies. The firm lost the audit, which went to more pliable accountants (not holding the degree of certified public accountant), and the original report was presented to the stockholders. Presumably the directors seized the opportunity to sell their stock in the holding company at a high price. At any rate, the holding company went into bankruptcy not long afterwards.

(b) A railroad company, when the time for the annual report and audit approached, deliberately withheld the intertraffic claims of other companies, amounting to a

considerable sum, by simply pigeon-holing the documents and not recording them as a part of their current obligations. This action was taken, it is stated, by order of the executive committee of the board of directors, who were about to ask authority for a new stock issue and who desired to bring out the issue shortly after the annual report appeared. The certified public accountants, who had charge of the annual audit, in this case discovered the deception through a general analytical study of the year's operations whereby it was seen that while such intertraffic claims ought to exist, they were not in evidence.

(c) An industrial company was enabled to maintain a market value for its stock through the payment of unearned dividends out of capital. The deficit was not shown on the books and was not known to the stockholders until after an audit by public accountants. Its existence, however, should have been known to the directors and in all probability was known during the period in which unearned dividends were declared. In this case judgment was obtained in the courts against the directors and restitution of the unearned dividends was obtained.

(d) In a case brought in the federal courts stockholders asked for the cancellation of stock alleged to have been fraudulently and secretly issued by the board of directors. It was stated that a person, to whom the certificate was issued without consideration to the company, executed to one of the directors a power of attorney authorizing him to vote the stock and delivered the certificate signed in blank. Thus, although no transfer appeared on the books of the corporation, the stock was actually owned and voted by one of the directors. As the stock of this corporation was widely scattered

and as the reports to stockholders were fragmentary and misleading, the whole transaction would have passed unnoticed if it had not been accidentally revealed to one of the stockholders. The court in this case merely cancelled the certificate in question and neither civil nor criminal liability was found to attach to the directors.

237. *An accountant's observations.*—A certified public accountant, whose experience in handling such cases has been exceptionally large, has been kind enough to sum up for the writer the results of his observations in the following note:

The methods employed for the purpose of giving a wrong impression to the stockholders or the public as to the company's condition as shown by the published balance sheet are almost innumerable, but I will cite a few.

Where the accounts are subject to audit and it is desired to make a good appearance at the date of the balance sheet, the practice of borrowing a large sum of money from brokers or bankers for a few days is often resorted to. By this means at the date of the balance sheet the company has apparently a large amount of available funds, though in point of fact the loan is repaid a few days later. In the same way, where such a corporation as a loan and investment company finds itself holding securities of a speculative character, such as mining stock, it is quite customary to make a sale of these securities to brokers a few days before the date of the balance sheet, with the understanding that the company is to repurchase them at the same price less commission for the accommodation a few days later. In this way the company avoids showing on its published balance sheet any investments that are not of a gilt-edged character, and in both the instances quoted above it is very hard for the auditor to find any grounds for refusal to give an unqualified certificate to the balance sheet; the condition is as stated by the accounts at the particular date at which they are drawn up.

Again, where it is desired to conceal from stockholders the fact that the company is making large profits or, on the other hand, incurring heavy losses, the valuation placed upon investments in stocks and bonds of other corporations or the valuation placed upon merchandise on hand is often juggled, the officers of the company constituting themselves the arbiters as to what is really the actual value of such assets.

Another window-dressing plan often employed is to treat the balances due on current account from the branch houses of the corporation as though they were accounts receivable due from ordinary customers. Goods on consignment are often similarly treated as though they were accounts receivable and included in the balance sheet at sale price under this caption instead of at cost price.

238. *Remedies for this kind of manipulation.*—What little has been said here with regard to juggling accounts by directors is sufficient to drive home at least one truth, namely, that the only safety for stockholders lies in insisting upon frequent and thorough examinations by certified public accountants of the highest standing. The chief asset of a public accountant is his unquestioned reputation for penetration and integrity. The loss of that reputation means the loss of his professional standing and of his clientele. He has, therefore, the strongest motive to lay bare the true condition of any corporation which he is called upon to examine and to state the exact facts to the stockholders. The stockholders may safely place confidence in him—unless, to be sure, he happens to be one of those black sheep, a few of whom find temporary employment in all professions.

In England it is customary for the stockholders themselves to elect a public accountant to serve as the annual auditor of their company. It will be a fortunate day for American stockholders when this practice becomes

prevalent also in this country. We may lay it down as a general principle that officers and directors who are worthy of their trust will not object to having their operations scrutinized at least once a year by an impartial and absolutely independent expert.

Another tendency which works indirectly toward the same result is the growing demand on the part of the people of the United States for publicity in corporation affairs. The demand for publicity is especially effective in the case of railroads and other public service corporations, most of which are now required to render complete annual reports either to the Interstate Commerce Commission or to some corresponding state authority. The primary purpose of this requirement is to obtain information that will aid legislatures and commissions in deciding upon reasonable rates and prices. It is doubtful, in the opinion of the writer, whether this result will be achieved. There can be no question, however, but that the interests of stockholders of such companies have been greatly advanced by a general adoption of this requirement. It is now possible for an investor to obtain such a complete and authoritative knowledge of the interior affairs of the principal American railroads as to make possible an intelligent judgment of the honesty and efficiency of the management.

Seeing the advantages that are thus gained, the stockholders of other large corporations are insisting more and more forcibly on a similar publicity and investors are refusing to buy the securities of companies which do not present satisfactory annual reports. That this attitude has for some years been making itself felt appears from the numerous conversions, referred to in Chapter XVII, of securities quoted on the New York

Stock Exchange from the unlisted to the listed group.

239. *Inflicting loss on the corporation.*—The fourth important method of manipulation by directors is through forcing heavy losses and frequently even bankruptcy on their companies. Here again a few examples selected from a mass of cases which the writer has examined will best illustrate the principal variations of this method.

(a) The G. and R. Railroad Company, a Kentucky corporation, constructed a road from Graceton to Rawlings for which it was heavily indebted. Robinson, a director, with the assistance of other directors, used the profits of the road to make improvements and thus made impossible the payment of interest on the outstanding bonds. The company was thus forced into bankruptcy and at the bankrupt sale all the property and rights were sold to Robinson. Robinson and others then formed a new corporation to hold the road. Five years later the stockholders of the bankrupt corporation brought suit against the heirs of Robinson to have the court adjudge the road as held in trust for the G. and R. Railroad Company. The court found that Robinson had violated his duties of trust by willfully mismanaging the road and misappropriating the earnings and, therefore, returned the property to the original stockholders, compensation being allowed to Robinson's heirs for the amount actually paid by Robinson for the road. Evidently Robinson's actions in this instance, although finally declared unlawful, would have passed unchallenged but for the enterprise and persistency of one or two of the stockholders.

(b) In a recent case in the federal courts, certain trustees of a building and loan association sold a valuable piece of real estate to a trust company, in which

some of the trustees were also interested, in exchange for securities of doubtful value. A mortgage on the real estate was taken from the trust company as a guarantee that the securities would realize the price agreed upon for the property, but by agreement the mortgage was not recorded. Later the trust company desired to sell the property and the trustees passed a resolution authorizing the cancellation of the mortgage, and it was cancelled without the knowledge or consent of the stockholders. Shortly afterwards the trust company became insolvent, the securities held by the building and loan association were found to be worthless and next to nothing was obtained for the property that had been sold. This may be taken as a typical instance of loss willfully inflicted on a corporation by its own directors.

(c) A corporation was indebted to its directors and they caused mortgage bonds to be issued to them for the indebtedness. The bonds were immediately assigned to a rival corporation. Before anything further had been done the stockholders learned of this transaction and brought suit for damages. The court held that the directors would be personally liable for whatever consequences of their acts might affect injuriously the interests of non-consenting stockholders.

(d) A stockholder of a Montana mining corporation in an action alleged that officers and directors in pursuance of a plan to depreciate the company's stock, in order to render practically worthless stock held by the plaintiff and others similarly situated, refused to sell treasury stock of the corporation in order to procure funds with which to prosecute assessment work on the company's mining claims essential to compliance with the state and federal laws. Further the directors sys-

tematically depreciated the value of the treasury stock by words and actions, refused to accept money offered therefor, removed the books of the company from the state, declined to give the plaintiff any information regarding the company's affairs and in general so conducted its business as to destroy the value of its shares. Their object in so doing was to make it necessary for the company to give up its mining claim in order that they might re-locate the property in their own names. In this case the court decided that fraud had been sufficiently shown and placed a receiver in charge of the property. The decision, however, would not have been reached except for certain imprudent remarks on the part of some of the directors.

240. *The danger in losing control of a corporation.*—The most interesting instance that has come to the writer's notice is given by a certified public accountant in one of the Western States, who vouches for its being a typical and actual case of manipulation by directors. He writes as follows:

A owned a majority of the capital stock outstanding in a manufacturing concern. Besides himself he had two dummies for the two other members of the board of directors. B desired to buy an interest in the concern and bought less than half of A's stock (leaving A still in control), with the understanding that B was to become a member of the board of directors, and that A and B should select another person whom they might interest at some future date when selling more stock. Therefore, they mutually decided to place a dummy temporarily on the board. B is a crook, as develops afterwards. C (the agreed-upon dummy) proves to be a bigger crook than B, thus giving B a majority in the board of directors. After this arrangement has been carried through, B and C trump up some imaginary charges against the methods of management of A,

and thus the majority of the board depose A as president and manager of the concern. A opposes the action and the case is brought into the court. B and C being the majority of the board of directors, the court upholds their action and gives an injunction against A not to interfere with B and C.

B and C then buy some worthless vacant property for a few dollars, which they appraise at an excessive value and sell to the company, taking stock in payment at the increased values. This stock is then divided between B and C, thus leaving A in the minority as a stockholder. The factory then burns down and a low settlement is made with the insurance companies, because suspicion was directed toward B for having set fire to the property. Their assets having thus been reduced, and wishing to make an excellent impression upon the court, and further wishing to hide their fraudulent action in placing the excessive value on the vacant, valueless property, they decrease the capital stock to about 10 per cent of the original capital stock. Each stockholder obtains his proportionate share of the new stock. In this manner B and C beat A from a half interest to a sixth interest.

They then incorporate a new company called The Investment Company, of which B and C are the only stockholders and in which B and C put up $5,000, which they loan out on improved realty to the manufacturing company, obtaining therefor a note secured by a mortgage.

They then proceed to incorporate another company, which succeeds the old manufacturing company. They value the assets of the old company at about one-third of what they stand on the books. The new company purchases the assets at the reduced value, giving the stockholders of the old company stock in the new concern in proportion of one to three, thus reducing the holdings of A from a half to an eighth interest in the same assets of which he was originally the owner. The new company then contracts with D, who is another crook, to build it a factory. The contract made with him is at a figure which is about $5,000 higher than the ordinary contractor would have built it

for. In addition to this B and C give him a large block of stock as a part consideration for the building of the plant. This $5,000 in excess of the real cost of the factory is paid to D every other day in cash and the books indicate that such cash was for his pay-roll. But circumstantial evidence points to the fact that these payments are bogus transactions on the books and that in fact the money goes into the bank account of the Investment Company.

Then the Investment Company begins to play treasurer for the new company, because it has no funds. Thus it loans the $5,000 back to the manufacturing company. The new manufacturing company needing more funds, the Investment Company sells the $5,000 note above mentioned to the manufacturing company, permitting the manufacturing company to credit the Investment Company for this $5,000 on its books. The manufacturing company then puts up the $5,000 note as collateral for a loan of $3,000 at the Bank. The result is that the Investment Company secures a credit in its favor for $5,000 for an actual value of but $3,000. After this transaction the Investment Company shows signs of anxiety for the money it has advanced, $5,000 in cash and $5,000 in notes. It therefore secures its claims by a mortgage from the manufacturing company on its new plant for $10,000.

The plant is completed, the stock bonus issued to the contractor, and this stock transferred to the Investment Company. Circumstantial evidence shows that no consideration was paid by the Investment Company to the contractor for this stock. As the case stands at present, the Investment Company is trying to foreclose its mortgage and if successful, will entirely defeat the interest of A, who in less than eight months was beaten out of a more than half interest in a successfully-run factory.

I was employed in this case by order of the court upon the complaint of A that B and C were wasting the assets of the company. I cannot see how under the laws of the state A has any redress whatever, except to show fraud in the first issue of additional stock and in the subsequent decreasing of the capital

stock. But from the point of view of law it will be exceedingly difficult to bring in this evidence. However, there is a ray of hope in the horizon; namely, that the state statutes forbid the directors to put a mortgage on a mining or manufacturing plant without calling a special stockholders' meeting and obtaining the consent of two-thirds of the stock. These directors had two-thirds of the stock and could have easily complied with the requirement but their attorney evidently overlooked this point and we believe that we can have this mortgage set aside and a receiver appointed. In this case the receiver could start suit against B and C and then bring out these fraudulent transactions.

The cases that have been cited seem scarcely to call for comment. They all—and especially the last case—however, give point to one precept, which controlling stockholders would do well to keep before them, namely DO NOT PART WITH CONTROL. A swindling or hostile board of directors can do more in one session to wreck a corporation and bring loss to its honest stockholders than a capable board can accomplish in years toward repairing the damage.

241. *Form of annual statements in Canada.*—Those interested in Canadian corporation finance have scope for considerable improvement in the form of presentation of their annual statements. An examination of such statements issued during any one year reveals numerous differences in the method of presenting these statements. It would not be so surprising to find differences between the financial statements of concerns carrying on businesses of different natures, but there does not seem to be a great deal of room for wide variation between those of firms carrying on exactly the same nature of business.

Bearing in mind that the object of a financial statement should be to place before the shareholders or the

public, generally, the exact position of the company at a certain date, there should be no great difficulty in presenting the various figures in such a manner as to accomplish this object. It will not be disputed, that in a large number of instances this is not done, and one might safely assert that in the majority of instances financial statements leave much to be desired.

Some examples of these lackings in the financial statements of some of the best-known concerns in Canada follow:

Various industrial concerns, which for years were the recipients of bounties from government, made no statement of the sums received on this account in their annual reports, but included them as profits.

A large industry first shows its dividends paid and later shows the amount of rent paid.

Almost fifty per cent of Canadian financial statements show somewhere near the top of the column the amount brought forward from the previous year, afterwards adding thereto the profits of the current year before making the necessary deductions.

Probably as large a proportion show, first, the dividends paid and afterwards make their appropriations for depreciation and other reserves.

This is not sufficient. Take, for instance, the first group mentioned. It would hardly be possible for anyone, not knowing that a firm was the recipient of a government bounty, to form a correct conclusion concerning that firm's earning capacity if the financial statement made no mention of bounties, but simply represented them as earnings.

242. ***What should be included in the statement.***—Mr. T. C. Allum, the Montreal correspondent of the ***Monetary Times of Canada***, discussing this matter, says:

One first looks at a statement to ascertain what the earnings of the current year were. First must be represented receipts due to the nature of the business. After this may be shown the costs of operation, divided into as many general headings as permissible. The total of these itemized costs is shown and is then deducted from the receipts of gross earnings. The remainder is the gross profits. Then should be shown, earnings from other sources which may be considered as regular and reasonably dependable. Then may be shown expenses of sale or management, the remainder being the net profits from operations. All these items should follow regularly and systematically, much as they would occur in the conduct of the business.

Then would be shown the bond interest and other fixed charges. This being deducted from the net profits from operations, would show the surplus or deficit for the year. This is probably what the shareholder has been looking for. It is also what the bondholder is looking for. Both are desirous of knowing what shape the company is in after all the charges have been met, which the company is obligated to pay during operations or on certain stated dates.

243. *Quarterly statements.*—There is some disposition in Canada for large corporations to issue quarterly statements to shareholders, as is done by many companies in the United States. The Dominion Steel Corporation issued the first of such statements concerning the operations of the company for the first three months, ended June 30, of the company's year. The statement did not give any further particulars than the amount available for dividends and dividends paid. The figures were:

Earnings available for dividends	$705,262
Dividends on preferred stocks	245,000
Balance	$460,262
1 per cent dividend on common	318,977
	$141,285

There is a division of public opinion in Canada on the advisability of such reports, however. One of the leading corporation presidents of this country is of the opinion that the United States Steel Corporation is not a guide for any ordinary company. With their enormous business, numerous plants, located at different points, owning their own railways, coal mines, ore deposits, and other properties, they can keep their statements practically regular from month to month. "The shares of our Canadian industrial companies," he added, "are largely held for investment, and these holders are quite content with annual reports. Monthly reports would be misleading, as owing to a strike or fire or changing from one contract to another, some months do not show any profit at all, and monthly reports would simply enable the brokers to 'bear' the stock in bad months. This would induce frightened shareholders to sell, and in good months the stock would be boomed and perhaps the same persons who sold the stock at a low price would buy it back at a higher price."

CHAPTER XXVIII

MANIPULATION BY AND FOR STOCKHOLDERS

244. *Cheating creditors.*—The subject matter of this chapter is concerned with manipulation directed toward one of two objects; either toward depriving creditors of some of their just rights for the benefit of the body of stockholders; or toward increasing the profits of controlling stockholders at the expense of minority interests. In the first case the stockholders may be either acting as a body, or manipulation carried on primarily for the benefit of the majority stockholders may be of such a character that the minority can successfully obtain a share in its advantages. Generally speaking, manipulation by and for stockholders as a body is confined to small close corporations. We shall find, however, one or two notable exceptions to this rule.

We are all of us familiar, some of us perhaps to our loss, with the old trick of an individual or partnership buying stock of goods on credit, disposing of it quickly and secretly, concealing the returns and shortly afterward going into bankruptcy. The trick may be worked by corporations as well as by partnerships or by individuals. Indeed, the corporation affords an additional advantage to the swindlers in that its bankruptcy need not affect them in the least. Credit-men understand the game in all its variations thoroughly and are especially cautious in granting credit to small close corporations, no matter how imposing may be their title and the capitalization. This scheme, of course, is simply

a plain case of fraud and has no especial interest for us in this study.

A slightly different method of reaching much the same result is to have a corporation pile up a large debt on the strength of its assets and then to allow the assets to depreciate. Stockholders of a corporation whose outstanding bonded debt is high are always under temptation to encourage this policy. By so doing they may secure large dividends for themselves over a series of years and at the end leave assets of small value to satisfy the bondholders. As we have already found in our study of corporate mortgages (Chapter IX) properly drawn instruments of this character provide that the property mortgaged shall be maintained in at least as good condition as at the time that the mortgage is drawn, on penalty of having the corporation put into the hands of receivers. If the trustee under the mortgage performs his duties properly he will see to it that this provision is enforced. If the stockholders and directors acting for the stockholders really desire to evade the provision, it may require the closest attention and rigorous action on the part of the trustee to forestall them.

245. *The Chicago and Alton deal.*—The well-known instance of the Chicago and Alton Railroad deal illustrates another variation of the same principle. The facts with regard to the Chicago and Alton manipulation which were fully brought out in an investigation by the Interstate Commerce Commission in 1907, may be briefly summarized as follows: A close syndicate in 1898 bought about 80 per cent of the outstanding common stock of the Chicago and Alton Railroad Company. The company had been managed with great conservatism for several years and had saved from its earnings

and put back into the property a surplus of $12,500,000. Now a surplus is legally, of course, the property of the stockholders of a corporation. It is so unusual, however, for stockholders to distribute this surplus directly to themselves that bondholders naturally look upon it as in part a protection to themselves and buy bonds with that understanding. Ordinarily, as has been explained, the surplus is invested in the form of permanent assets of the corporation, and the value of these assets is a strong factor in influencing the bond buyer. The syndicate of common stockholders in this case, determined to secure for themselves, and incidentally the other stockholders, the accumulated surplus of the company. They therefore issued new bonds to the extent of $32,000,000, which were sold at 65 and the proceeds, about $21,000,000, turned into the company's treasury. They then declared an extra cash dividend of 30 per cent and thus transferred a large share of the cash obtained by the bond issue into their own pockets. The action was much discussed at the time, was condemned by some and defended by others, but did not arouse much public interest until the investigation by the Interstate Commerce Commission in 1907 brought it into prominence. Then, probably to the surprise of the members of the syndicate, the verdict was practically unanimous against them. They were tried before the bar of public opinion and were found guilty of misuse of corporate funds which had been entrusted to their care. There can be no question but that this unanimity on the part of the public is highly significant. It means that between 1898 and 1907 a notable gain in the public's knowledge of corporation finance and in the public's conception of what is and what is not justifiable had taken place. The gentlemen who composed the

syndicate ought not to be too severely criticised, for they merely acted in accordance with the custom of the period. We may well hope and believe that manipulation of this kind and of the other kinds that have been enumerated will become less and less frequent as our conceptions of the trusteeship implied in almost all corporate activities become clearer.

246. *Manipulation through subsidiary companies.*—Another method that is very commonly used when stockholders plan to get the better of the creditors of their corporation, is the device of interposing one or more corporations between the creditors and the assets on which they think they have a claim. A case in point which was recently settled out of court, and in which the names of the parties concerned, therefore, cannot here be given, is that of an amusement company operating a large park in one of the cities of the United States. The operation of the park was extremely costly and, as the price of admission was only ten cents, the returns were not sufficient to pay expenses. There were, however, a large number of shows and amusement enterprises in the park which were highly profitable. The stockholders of the corporation as individuals were interested in these sideshows and secured large profits. The corporation which owned the park, on the strength of its apparent prosperity, was able to borrow large amounts of money. When the time for settlement came the creditors learned the true state of affairs and were informed that their claims were practically worthless. Fortunately in this case they were able to bring such pressure to bear on the stockholders that their claims were settled. It is quite evident, however, that as a method of getting loans and avoiding re-payment the scheme is workable.

Here is another instance which shows that eminent and entirely respectable railroad directors are not above working the same trick for the benefit of their road. The N. E. Railway owned a majority of the stock of a small rail and boat line which had income bonds outstanding. The large company, being in control, was able to apportion traffic and earnings as it pleased and gave less than its share to the small line. Three of the boats owned by the small company were being paid for on the installment plan and one of these payments was allowed to lapse, thereby forfeiting the interest of the small company in the boats. The large railroad company then bought the boats from the vendors, being allowed the amount which had already been paid by the small company. Then a consolidation of the large and the small companies was determined upon and, as the earnings of the small company had been practically stopped, its shareholders received only one share in the new consolidated company for every ten shares in their possession. The income bondholders received no interest after the large company came into control and when the consolidation took place were compelled to consent to a great reduction of their claims. The case was threshed out in the courts and it was decided that all the steps taken were legal, except the voluntary passing of the payment on the boats.

247. *Central of Georgia income account.*—Another case in point, that several years ago attracted a great deal of attention in the financial world, was set forth in the suit of income bondholders of the Central of Georgia Railroad Company for the payment of interest in full on the bonds. The reader will recall that in describing the nature of income bonds it was stated that they are falling into disuse on account of the in-

evitable disputes that arise as to what are and what are not profits. The bonds in question were issued in 1895 at the time of the reorganization of the old Central Railroad and Banking Company of Georgia.

This case well illustrates the subject now under discussion, inasmuch as it discloses one method of manipulation in favor of stockholders at the expense of creditors. The principal fact alleged by counsel for the income bondholders, and practically admitted by the railway company, was that a subsidiary corporation, the Ocean Steamship Company, almost all of the stock of which is owned by the Central of Georgia Railway Company, had been making large profits and that these profits had been appropriated by the railway company. Evidence disclosed that the Ocean Steamship Company kept no separate bank account but deposited all its funds to the credit of the Central of Georgia Railway Company. There were, however, separate books of account for the two companies and it was claimed at the suit, on behalf of the railway company, that the earnings of the steamship company were simply loaned to the parent corporation. These earnings, the reader should understand, were not used in order to declare dividends on the stock of the Ocean Steamship Company held in the treasury of the railway company, but were turned over bodily under the fiction of a "loan"; therefore, the earnings of the steamship company did not appear at all in the income account of the railway company, and the railway company thereby avoided showing sufficient profits to pay interest to the income bondholders. The counsel for the railway company urged, according to the brief of petitioners' counsel, "that the net earnings of the steamship company should not be included in the income account of the railway company and that unless

a dividend is declared by the steamship company no part of the net earnings of the steamship company belong to the railway company or are pledged to the bondholders, and that the question of declaration of a dividend is a matter of discretion lodged with the board of directors of the steamship company, with which a court of equity should not interfere. In other words, the railway company interposes the doctrine of 'corporate entity' and desires to have what it regards as the 'sacredness' of the doctrine taken cognizance of by a court of equity."

The decision of the court in this case, which was rendered after long and hard-fought litigation, was in favor of the complaining bondholders. It would certainly seem clear to a layman that the subsidiary corporation was here used as a device to prevent the income bondholders from securing profits justly due.

These cases are sufficient to show what risks creditors may unwittingly take on themselves and how careful they should be in fixing the terms of their mortgage. Especially is this true in dealing with corporations which carry on several activities and which may through separate companies readily divert their earnings from the rightful creditors to the stockholders.

248. *Squeezing the minority stockholders.*—We are ready now to take up the second group of manipulative methods to be discussed in this chapter, namely those methods which are designed to enrich controlling stockholders at the expense of minority interests. Let us consider first the following instance, taken from a Missouri court decision, of willful mismanagement:

The Olympic Theatre Company was organized in May, 1908, with a capitalization of $50,000. E. S. James, Sr., obtained 240 shares, par value $100, and

J. S. McIntosh, 150 shares; the other 100 shares were never issued. Three days after the organization the company obtained a hundred-year lease of a lot in St. Louis. Under the terms of the lease the company was to pay the owner a rent of $2,500 for the first two years and thereafter at the rate of 6 per cent of the appraised value of the lot. The company had the right to purchase at the appraised value at the end of five years. The lease was to become void by non-performance of any of its conditions and, in the event of its being voided, the owners of the lot were to get full title to whatever buildings the theatre company might erect on the lot. The company erected a building and conducted a theatre.

In 1905 McIntosh sold his stock to Robert Henry, and Henry became a director and treasurer of the company. E. S. James gave ten shares of stock to his son, E. S. James, Jr., and made him the third director. In 1907 James, Sr., transferred ten shares to another son, Alfred James, and ten shares to a clerk, L. R. Osgood. In the same year the new board of directors elected were James, Sr., James, Jr., and Osgood, thus forcing Henry out. In 1908, as the company was not strong enough financially to buy the lot, the stockholders gave the directors the right to dispose of the company's option to any stockholder. The directors immediately sold the option for $50 to James, Sr., who thereupon resigned as president and director and had his son Alfred elected in his place. James, Sr., then used his option to buy the lot for $50,000 and made an agreement with the company fixing its appraised value at $65,000 and its annual rental at $3,500. Alfred James then resigned his offices and his father was re-elected president and director. The board failed to pay the

rent when due and James, Sr., as owner of the lot under the terms of the lease to the company, declared the lease void and was placed in possession of the lot and the building erected thereon. Henry, the minority stockholder, brought suit and it was finally decided that sufficient evidence of fraud had been produced to warrant the court in reinstating the lessee in possession of the theatre under the terms of the lease.

It may be inferred from the decision that two factors which decided the court in favor of the plaintiff were, first, that the James family were evidently acting as a unit, and, second, that the books of the corporation had been destroyed. These were tactical errors which might readily have been avoided; if they had not been present, it is safe to say that the whole series of transactions would have been found legal.

A more simple and common case is stated in a recent decision of one of the federal circuit courts. The officers and owners of a majority of the stock of a wire company voted as stockholders to lease the property of the company at a low rental to another corporation, all of whose stock was held by these same majority stockholders. No fraud was shown and the petition of the minority stockholders to set aside the lease was not granted.

In another federal court case it was shown that the majority stockholder of a gas company absolutely dominated the board of directors and induced the board to purchase worthless bonds of another corporation in which he was interested, by which he was able to make a large individual profit. Here again the minority stockholders, in spite of their unremitting efforts, were unable to prove fraud.

249. *A complicated real estate proposition.*—Here is an instance furnished by a prominent accountant

and which is stated to be typical of the operations of a certain group of companies. The Suburban Development Company is a close corporation which speculates in acreage and sells lots on a commission basis. The company sells a piece of property belonging to an outsider, Smith, to the Redbank Realty Company. This last named company is in reality a subsidiary corporation, all of whose stock is owned by the Suburban Development Company. The Suburban Development Company collects a commission from Smith for selling his property.

The company now organizes a third corporation, the Long View Land Company, which buys the property at a handsome advance and assumes the mortgage which was on the property when Smith owned it. The Long View Land Company, in addition to assuming the mortgage, issues all its stock to the Suburban Development Company for the balance of its purchase price. The Long View Land Company now makes a contract with the Suburban Development Company whereby the last-named corporation sells the lots on a commission of 20 per cent. The Long View Land Company is also charged an exorbitant amount for office rent and pays large salaries to its officers, who are the stockholders in the Suburban Development Company.

The Suburban Development Company now pushes the sales of the lots owned by the Long View Land Company. When no outsiders can be induced to buy, other subsidiary corporations are formed which buy lots at high prices from the Long View Land Company. Thus this company is given a fictitious appearance of great prosperity and a surplus is created on the books. With such a showing it is easy to find purchasers of the

stock of the Long View Land Company, which is in the treasury of the Suburban Development Company. After all but the controlling shares are sold, the subsidiary companies which have bought lots from the Long View Land Company go into bankruptcy, the lots are returned and the paper profits of the Long View Land Company suddenly vanish into thin air.

The object of this complicated series of transactions, as the reader will see, is simply to sell the minority stock of the Long View Land Company. The majority shares must be retained in the hands of the manipulators in order to avoid investigation and litigation. The company advertised and kept before the public in all these transactions is, of course, the Long View Land Company. All the time, however, the stockholders of the controlling corporation are calmly pocketing all the real profits.

The above illustrations are typical. It would seem impossible to enumerate all the possible variations in method. The feature common to them all, however, is the transfer of property from one corporation to another corporation owned by the majority stockholders of corporation number one. This is what the minority stockholder must always fear and, so far as possible, provide against. There is no other way of preventing such manipulation except by associating only with honest majority stockholders in companies where the fullest publicity obtains.

250. *Robbing a partnership to pay a corporation.*—One more instance should be added to the list already given, for it shows very clearly what may be accomplished in the way of defrauding helpless and ignorant minority owners.

James Ehrenbahn, a partner in the firm of L. A.

Ehrenbahn and Company, manufacturers of agricultural implements, died in the year 1896. He had an undivided one-fourth interest in the firm and in addition had loaned the firm $3,000. He also had a one-third interest in a credit against the firm of $12,000, the other two-thirds belonging to his brother, L. A. Ehrenbahn. The firm held property whose book value was approximately $260,000. Immediately after the death of James Ehrenbahn the surviving partners caused to be written off to profit and loss accounts and bills receivable alleged to be uncollectible amounting to $110,000, leaving a net book value of the property of the firm of approximately $150,000. L. A. Ehrenbahn was acting not only for himself but also for the estate of his brother, of which he had been appointed administrator. The surviving partners made no attempt to close the affairs of the firm, but continued in business and made large profits, of which they rendered no accounting. In continuing the business they used up money and property belonging to the estate of James Ehrenbahn.

About October 1, 1898, the surviving partners agreed to form a corporation, lease to it the plant and real estate of the co-partnership and sell to it on credit, the terms being indefinite, the personal property, accounts and bills receivable in the hands of the surviving partners. The corporation took over the inventory of finished products at an appraised value to be paid for out of money received from the sale of implements on hand. The organization of the corporation was in 1898 and its operations began the same year, but no stock was issued until 1903.

A peculiarity of the business thus transferred was that large amounts of agricultural implements were

sold "on consignment" to agents who had the privilege of either returning the goods or of paying for them. The corporation now began to deal with these agents, sent them new stocks of goods and allowed them without protest to return the goods which had been sent them on consignment by the partnership; thus the accounts and bills receivable of the partnership were rendered worthless and their place was taken by accounts receivable of the corporation. Furthermore, the corporation used no diligence in collecting the accounts receivable of the partnership that were left outstanding.

In March, 1903, L. A. Ehrenbahn for himself, and assuming to act as administrator of his brother's estate, delivered a new lease to the corporation of the land and buildings belonging to the partnership at the excessively low rate of $1,000 a year. In the same year the partnership made a final sale to the corporation of the personal property for $20,000, although this same property had been valued in 1898 at $50,000. Between 1898 and 1903 the corporation paid nothing for the property or for its use. Beginning in 1904 the corporation paid annual 10 per cent dividends on a capitalization of $100,000. The record does not show what dividends were paid between 1898 and 1904. When the case came into court on complaint of the heirs of James Ehrenbahn decision in substance was that the corporation should be compelled to pay a price to be fixed after investigation by a master for the personal property and real estate. It was adjudged, however, in the case of accounts and bills receivable, that no legal liability lay against the corporation.

There can be no question, judging from the facts as presented to the court, that large sums had been deliberately withheld from the partnership and transferred

to the corporation by the manipulation of the accounts and bills receivable. Yet this manipulation could be carried on so easily by the corporation that it was impossible to prove fraud or bad faith.

251. *Remedies for manipulation.*—The examples that have been cited in these three chapters on corporate manipulation seem to the writer not only interesting but highly instructive. It is an unpleasant duty to record instance after instance of cunning rascality, especially when the record to be truthful must set forth at least temporary successes on the part of the rascals. As was said at the beginning, the swindling operations are for the most part in a field which the law does not reach and their perpetrators are seldom given the legal punishment to which they are justly entitled. Fortunately the punishment of social opprobrium and loss of business standing is generally visited upon them.

The purpose of these chapters will have been secured if they serve to warn owners of corporate securities of the facilities which the corporate form affords for graft and dishonesty. The writer desires to reiterate that instances of the kind that have been narrated are rare compared with the vast amount of entirely honorable and legitimate business transacted under the corporate form of business organization. Nevertheless they are frequent enough to demand attention and, so far as possible, prevention.

One preventive is for security-holders to insist on complete and absolute publicity as to the affairs of their organizations.

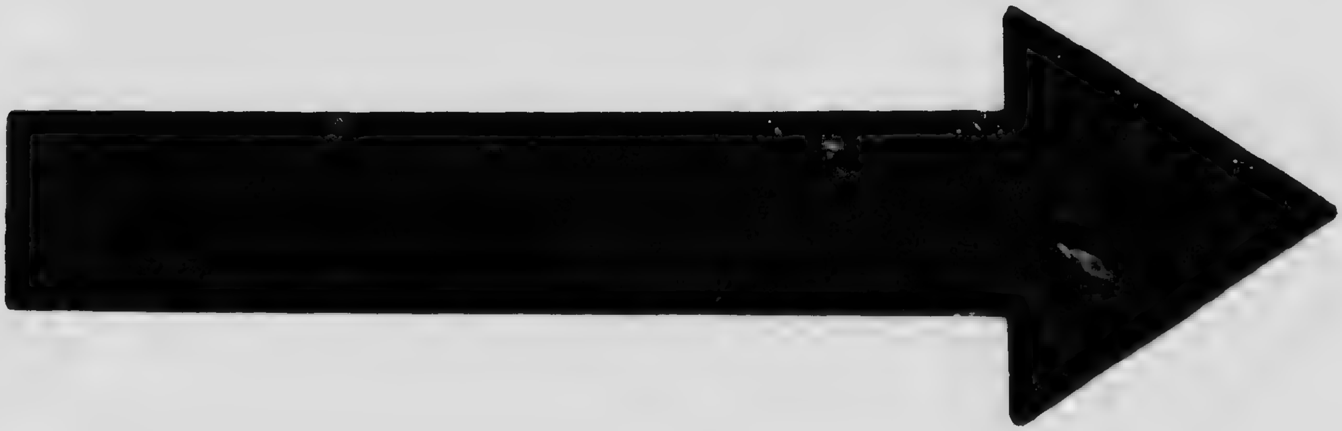
Another preventive is for them to attend stockholders' meetings and take an active interest in all that goes on in the corporation.

A third preventive is to see to it that under the cumu-

lative system of voting every stockholder gets a chance to be represented.

A fourth preventive is to insert explicit provisions in the corporate by-laws as to salaries of officers, amount of indebtedness to be incurred, amount of surplus to be set aside each year, and so on.

The best preventive of all, however—without which all the other measures will prove of small avail—is for the security-holder to investigate with the greatest care the reputation of all the officers and directors of the corporation.



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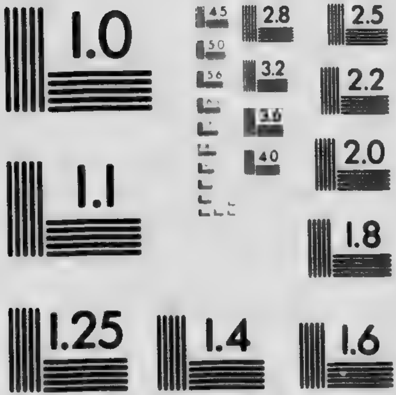

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CHAPTER XXIX

INSOLVENCY AND RECEIVERSHIPS

252. *Two types of insolvency.*—The causes of insolvency have perhaps been sufficiently indicated in connection with the subject of management of capital funds and of earnings. At any rate, they may be inferred to be the reverse of the principles of sound corporate finance, which were there laid down. It will do no harm, however, to recapitulate briefly the prinicpal causes. A great many business men, even the managers of large corporations, are evidently not fully alive to the dangers which threaten any corporation.

It is well to distinguish between two types of insolvency. The distinction for our purpose is important, although in law and in ordinary business language it has not been clearly kept in view. We may call one type "true" and the other "legal" insolvency. True insolvency exists where the value of an individual's, firm's or corporation's assets is less than its total debts. This, by the way, is substantially the definition given in the National Bankruptcy Act, but it is declared by eminent legal authorities to be a definition without precedent in the law. Such insolvency may or may not lead to failure. Certainly if failure is not to follow there must be an improvement in the condition of the business. It frequently happens, however, where debts are not immediately payable, that a concern insolvent in this sense will manage to pull out of its difficulties and meet its obligations when they finally mature.

Legal insolvency exists when a concern's cash assets are insufficient to meet its liabilities as they fall due. It may well be, and frequently is, true in such a case that the total assets would far overbalance the total obligations. As obligations are almost uniformly payable in cash and cash only, however, it really makes no difference how great the value of the firm's unsalable assets may be. Legal insolvency almost of necessity leads immediately to suspension or, in the case of small concerns, to bankruptcy. The only escape would be a compromise of some kind accepted by creditors.

253. *Causes of true insolvency.*—True insolvency may exist from the very beginning of corporate existence, although not usually without bad faith on the part of the incorporators. It is possible, however, that the value of a corporation's assets at the beginning may be honestly over-estimated, that the corporation may borrow an undue amount of money secured by such assets, and that the money thus obtained may be foolishly expended. In such a case, unless a marked rise in the value of the assets takes place, the corporation may be said never to have been truly solvent. It is only a question of time until the inevitable failure arrives.

A second cause of true insolvency may be a great and perhaps unavoidable decline in the value of a corporation's assets. If, for instance, a cyclone demolishes the property of a corporation that does not carry insurance against such a calamity, insolvency will necessarily be the result. The fall in the value of the assets may be due simply to ordinary causes, which are not offset by a depreciation reserve. Any one of a hundred other events, which will occur to every reader, may reduce the value of assets below obligations. It may be stated, however, that a conservatively managed corporation is

not likely to suffer in this way. The principles of insurance and of depreciation are now so widely applied that a high degree of protection is afforded.

The third cause of true insolvency, especially with trading companies, is bad management in buying and selling goods. The lack of a proper system of cost accounting may lead corporation managers to a long-continued course of selling below cost. The fact that such a course has been followed may not become entirely apparent for a number of years; then it is found that the corporation has been gradually consuming its capital funds in order to pay running expenses.

The complexity of modern business is such that frequently an accurate and searching analysis carried on at considerable expense is necessary in order to determine whether a business is being carried on at a profit or not. Many a concern has seen its sales growing, its gross profits swelling and apparently its surplus increasing, while at the same time, owing to lack of care to maintain its fixed assets in good condition and to keep up its established trade, it has in reality been moving rapidly into insolvency. An anecdote is told of a large wholesale dealer in men's clothing who was selling quantities of goods at prices which expert accountants found to be considerably below cost, including in cost all the selling and administrative expenses. The accountant approached the manager of the company and asked him how he could afford to carry on his business. "Ah," was the naive reply, "you see our transactions are on so much larger a scale than those of any of our competitors." It seems needless to add that this particular concern did not long keep out of the bankruptcy court.

The fourth cause of true insolvency is actual fraud

or theft, a cause which need not be here discussed.

254. *One cause of legal insolvency—"lack of capital."* —As to the causes of legal insolvency, we have a valuable mass of information collected by the two great mercantile agencies, Bradstreet's and Dun's. The Bradstreet Company summarize their judgments as to the prime causes of all the business failures that occurred in the United States during the four years preceding the crisis of 1907, in the following table:

Causes of Failure.	*Percentages.*			
	1907	1906	1905	1904
Incompetence	22.6	22.3	24.4	23.1
Inexperience	4.9	4.9	4.8	5.1
Lack of capital	37.1	35.9	33.4	32.2
Unwise credits	2.3	2.6	3.5	3.4
Failures of others	1.4	2.0	2.2	2.5
Extravagance	.9	1.0	1.1	.8
Neglect	2.5	2.2	2.9	3.1
Competition	1.2	1.0	1.5	1.3
Specific conditions	16.3	17.3	16.3	19.1
Speculation	.7	.8	.7	.8
Fraud	10.1	10.0	9.2	8.6

The reader will notice that "lack of capital" heads the list and that personal incompetence comes second. Unfortunately no distinction is made between lack of permanent capital and lack of working capital. It seems safe to say, however, that lack of permanent capital does not usually in itself lead to insolvency; most businesses may be automatically adjusted to any reasonable amount of capital. The difficulty comes rather in the form in which the capital funds are invested, particularly in sacrificing quick in order to build up fixed assets.

To make this statement concrete let us examine the *Wall Street Journal's* analysis of two typical instances of financial difficulty. In February, 1909, the American Ice Company was reported to be facing insolvency

and reorganization and the *Journal* commented as follows:

> The annual report just submitted shows that the floating debt, about $650,000 a year ago, has now reached the threatening proportions of something like $1,250,000. Herein lies the whole trouble with the American Ice Company. The concern transacted a gross business during the year ended October 31, of $8,120,000, and it is clear that to maintain this volume of business ample liquid capital is essential. The report evidences the need of working funds in other ways; it shows that $72,728 was expended for interest on its floating debt.
>
> Where the company will raise money is a problem. It is known that institutions friendly to the company which have helped it out of difficulties in the past, have withdrawn further support. The company has little credit of its own to borrow on. The treasury contains several hundred thousand dollars worth, par value, of securities of subsidiary concerns, but these are hardly sufficient for collateral for a loan as large as American Ice requires.

Evidently the company was in danger of legal, not true, insolvency. After the above paragraphs were written the ice company denied its allegations and asserted that it was not in serious need of financial assistance. Nevertheless the quotation indicates clearly enough where a trained financial writer looks for symptoms of weakness.

255. *The case of the Detroit, Toledo and Ironton Railway Company.*—The paragraphs that follow constitute an attempt to explain the failure of the Detroit, Toledo and Ironton Railway Company.

> The company in question, a reorganization of the old Detroit Southern, began business in the early part of 1905. When the management of the property again passed into the hands of the court this year, its new career had lasted about two and a

half years, during no part of which had it succeeded in earning the fixed charges which the capitalization of the reorganization plan had fastened upon it. In the first full fiscal year of its operation as an extended system, the deficit after payment of interest charges and taxes amounted to $270,000; in the second fiscal year which ended June 30th last, the deficit reached the sum of $371,000. After that, presumably, the company ran still further behind.

As to the question of working capital, the Detroit, Toledo & Ironton's balance sheet of June 30, 1905, practically the beginning of its career, shows current assets of $1,218,524 and current liabilities of $390,194, making an apparent working balance of $828,330. Among these current assets was an item, "due from reorganization committee, $1,050,000." A year later this item had disappeared into equipment account, and the inference is that it never was a part of true working capital. In that case, the new company began without any working capital, but with an actual funded debt of about $200,000.

If President Zimmerman's theory that the receivership is primarily attributable to the clause of the Hepburn law which forbade the company to proceed with its Kentucky coal mining project is true, the Detroit, Toledo & Ironton as it exists was not a success to begin with. That is, it did not have and could not obtain a current revenue sufficient to carry its own obligations, aside from the cost of the Ohio River Bridge and Kentucky extension, and could only become a self-sustaining property by tapping an entirely new and rather distant source of traffic. Such a development naturally could not take place except through the investment of much additional capital and the completion of works bound to take a year or two in construction. Meanwhile the company was exposed in a perilous financial condition to the usual danger of adverse general conditions, which did not fail to arrive.

The two causes assigned in this case are: First, lack of earning power in the assets sufficient to meet fixed charges, which is a condition of true insolvency;

and, second, lack of current assets, or of working capital.

256. *Additional causes of legal insolvency.*—We have found in our study of financial management that it is not usually advisable for a concern to allow its accounts payable to exceed 70 to 80 per cent of its accounts receivable; that its bank loans should be represented for the most part by cash in the bank; and that its finished products on hand should not be offset by any corresponding liability. If these relations are not maintained, the company is apt to sink first into an unprofitable and next into a highly dangerous situation. The concern begins to lose profits, if its working capital is insufficient to permit taking full advantage of all considerable discounts for the prompt payment of bills. This point has already been discussed in connection with financial management. It is obvious that as working capital decreases the corporation manager is driven to depend more and more upon his current sales and accounts receivable for funds with which to pay his bills. If for any reason his sales fall off sharply or his debtors fail to pay promptly, he will be unable to meet his own obligations promptly. Unless he can secure extensions or arrange for loans from some other source failure is inevitable.

Let us give attention again—for this is an important point—to the fact that a concern may fail in this manner although its assets may be thoroughly sound and far in excess of obligations, its business large and growing, and its profits great. Carelessness or lack of appreciation of the necessity of keeping up working capital may thus be the sole cause of legal insolvency. As to the statement that the trouble with many concerns is "lack of capital," our analysis has indicated that the proper

wording of this phrase in most cases would be "lack of working capital."

A slightly different cause of legal insolvency arises when a corporation, in order to pay dividends, unduly increases its quick obligations. It may well be in such a case that the dividends have been earned and are properly due to the stockholders. If the profits that are to be used for dividends, however, have been put back into the property or into any sort of permanent investment, the payment of the dividends will involve borrowing money. Among conservative financiers this is universally regarded as a dangerous practice. Dividends ought to be provided for in advance by so large an accumulation of cash that their payment will not unduly reduce, even temporarily, the corporation's working capital.

A third frequent cause of legal insolvency is inability to renew medium term notes or refund long-time obligations when due. This siuation may not be the fault, so much as the misfortune, of the corporation. The obligation may fall due during the height of a crisis when borrowing of money on any terms is next to impossible. It may have been entirely proper to issue the obligations in the first place; the assets may be far more than sufficient in value to cover them: and yet the actual cash to meet them may not be forthcoming. We shall have occasion in the following pages to discuss a recent case of failure and reorganization which falls within this class.

257. *Two methods of handling insolvency—Bankruptcy and dissolution.*—There is so much confusion—not only in the public mind, but even among lawyers—as to the exact nature of the remedy that should be applied when a corporation gets into financial difficulties, that it seems proper to preface our study of corporate

reorganization by a brief survey of the legal aspects of insolvency, receivership and bankruptcy. Much of what is said in this chapter will apply to individual proprietorships and to partnerships, as well as to corporations. Additional information on the topics here briefly treated will be found in the volume on COMMERCIAL LAW.

The reader is probably already aware that the constitution of the United States confers upon Congress the sole authority to establish a uniform law as to bankruptcy procedure for the whole country, and that the latest expression of this authority is found in the National Bankruptcy Act of 1898. Bankruptcy may be either voluntary or involuntary. It may be asked for by an insolvent individual or partnership in order to obtain a discharge from his or its debts; or it may be asked for by creditors whose claims are unsatisfied in order to obtain an equitable division of the property of the bankrupt. The Bankruptcy Act, as amended in 1910, provides that all corporations, except municipal, railroad, insurance and banking, may file voluntary petitions in bankruptcy; involuntary petitions may be filed against all "moneyed, business and commercial" corporations except municipal, railroad, insurance and banking corporations. It will be noticed that charitable and religious corporations are not prohibited from filing voluntary petitions. The presumption is that they may do so. As a matter of fact, it is seldom to the interest either of stockholders or of creditors to force a corporation into bankruptcy. Indeed, the chief reason that may lead to such drastic action is the desire of unsecured creditors to prevent secret deals and transfers of the corporation's assets and to expose any past irregularities in the conduct of the corporation. Bankruptcy is espe-

cially valuable at times as a means of making invalid liens or judgments that have been secured by favored creditors within four months of the period of bankruptcy.

A second method of handling the affairs of an insolvent corporation is by a dissolution of the corporation and a distribution of its assets to creditors and shareholders. This method is even more infrequent than bankruptcy and is plainly out of place except for corporations, the organization and good will of which are not worth saving.

258. *A third method—Appointment of a receiver.*—A third method is the use of what is known in law as a "bill in chancery." The objects sought to be obtained by this method are, first, to come to an equitable settlement between the corporation and its creditors, and, second, to preserve the corporation's organization and continue its business. The "bill in chancery" is, in lay language, simply a petition presented to a court of equity asking the court for protection and supervision of the corporation's property and business until a settlement of the conflicting claims may be secured. If the petition is granted, the court at once appoints an officer responsible solely to the court known as a "receiver," whose business it is to conduct the corporation's affairs until he is discharged. The petition may be presented by any one of four parties: (a) the corporation itself; (b) the stockholders; (c) secured creditors; or (d) unsecured creditors.

A petition of this character presented by a corporation in its own name is unusual and instances of its being granted by the court are still rarer. It is also somewhat unusual to find petitions by stockholders presented and granted. A complaining stockholder is usually told by

the court that his proper course, if he is dissatisfied with the management of the corporation, is to elect new directors. Moreover, a complaint by a stockholder that his corporation is insolvent and should be placed in a receiver's hands is seldom necessary, for in such a case creditors will be more than likely to take the initiative. Where the corporation itself is willing that a receiver should be appointed the petition is usually presented by friendly unsecured creditors. This is, in fact, the usual method of securing what is known as a "friendly receivership." It is doubtful, however, in many states, whether an unsecured creditor can successfully apply for a receivership in the face of opposition on the part of a corporation. Secured creditors have a far stronger case and a petition on their part based on the proved insolvency or mismanagement of the corporation is not generally denied.

Unlike petitions in bankruptcy, bills in chancery may be presented either in the federal courts or in any of the state courts which have jurisdiction. Here is a frequent cause of much confusion and frequently of conflict between courts. The legal questions involved are entirely too complicated and technical to be discussed in this chapter. All that need be said is that where large inter-state corporations are involved the tendency is growing to apply to the federal courts for relief. One reason is that the judges of these courts are especially familiar with cases of this kind; another reason of still greater importance is that federal judges in different parts of the country work together more harmoniously than do the judges of different states.

259. *Duties of a receiver.*—If the corporation is carrying on simply a trading business and goes into bankruptcy, the activities of the receiver in bankruptcy will

be comparatively simple. He will dispose of the assets as rapidly as he can and will use the funds thus obtained, so far as they will go, to settle with creditors. There may be a considerable waste in this process, for the established trade and business connections of the failed company will go for nothing. Yet, on the whole, it is the quickest and most certain method of satisfying the obligations of the company, and it is usually followed. Unless the corporation's borrowings have been far in excess of the value of its tangible assets, the obligations will be met and the loss will all be borne by the stockholders. In an ordinary bankruptcy the stockholders' interests are very little considered.

Where the failed corporation is a large manufacturing or railroad company with a great amount of fixed caiptal and a receiver is appointed by a court of equity, his duties are entirely different. He has as his object in this, as in the former case, the payment of corporate obligations. It is very seldom, however, that this object, when the corporation has large fixed assets, can be attained by the sale of these assets. Ordinarily there is no one to buy them except at a tremendous sacrifice. It would evidently be quite impossible to find cash buyers for the millions of dollars of property of any of the great industrial combinations or of any of the great railroads. Therefore, the receiver is permitted in such a case to go on with the business. No profitable activities of the concern are allowed to cease. It goes on manufacturing or transporting, or whatever its business may be, under the receiver's administration, just as it did under the administration of its own officers. As the holders of claims against the failed corporation cannot hope for immediate payment in cash, a settlement with them must be made in some other manner—usually

through a reorganization, a subject to which considerable attention is given in the following chapters.

260. *Receiver's powers.*—The receiver is a very powerful official. So long as no actual fraud or obvious mismanagement on his part is proven, he is at liberty to make such disposition of the assets and earnings under his charge as he sees fit. He may use his power altogether for the benefit of the creditors, or he may use it in part also for the benefit of the stockholders. If he has the latter object in view, he will naturally do what he can to delay a settlement until a favorable period arrives and will thus preserve as much of the property as possible for the stockholders.

In view of his power it is always very important to the stockholders—and frequently more equitable to every one concerned—to have a receiver of their own choosing appointed. In recent years it has become customary for corporations which are getting into difficulties to secure from the court the appointment of what are generally known as "friendly" receivers. Frequently the friendly receivers are officers of the corporation. In order to get this result there must be collusion between one or more of the creditors and the corporate officials. The creditor or creditors and the officials go secretly—often at dead of night—to some judge who has jurisdiction; the creditor complains that his debt is unpaid and the officials confess insolvency; then the creditor asks for the appointment of some man previously agreed upon to act as receiver and the judge then and there duly appoints him. Of course, the judge must be fully aware of this scheme and must approve it. On account of the conflicting jurisdictions of our state and federal courts, however, it is usually a very easy matter to find one among the several judges

with the proper authority who will do what is wanted. It will not do to say off-hand that in every case the appointment of friendly receivers is absolutely wrong, or that the judge who makes the appointment is corrupt. As has been intimated, insolvency sometimes results from causes beyond the control of corporate officials and hasty action on the part of receivers would cause heavy unnecessary loss. We cannot absolutely condemn, therefore, either the officials who request the action or the judge who complies with the request. Nevertheless, the transaction, being secret and more or less irregular, seldom reflects credit on any one concerned.

Since the receiver, however he may be appointed, is a court officer, his expenses are court expenses and until paid constitute a lien on the corporate assets that goes ahead of all other claims. Receivers' certificates may be issued in order to secure funds for practically any purpose that the receiver deems proper. The funds may be used to purchase new supplies or equipment or to improve and extend the property.

261. *Business failures in Canada.*—The following statistics of Bradstreet's shows the record of failures in Canada during 1911 and 1912. Considering the large number of companies in operation and their immense capitalization in the aggregate, the list is small:

Failures due to	Number		Assets		Liabilities	
	1912	1911	1912	1911	1912	1911
Incompetence	214	226	$1,121,328	$1,317,774	$ 2,815,349	$ 2,471,299
Inexperience	67	41	204,761	93,032	435,468	200,851
Lack of capital..	660	691	2,784,605	2,930,854	5,660,668	6,249,820
Unwise credits...	17	12	148,524	62,250	204,744	130,244
Failures of others.	12	16	77,967	117,125	311,333	188,023
Extravagance	11	12	29,460	308,000	65,510	417,900
Neglect	56	58	172,871	183,610	377,384	332,792
Competition	13	15	39,538	33,699	78,958	74,150
Specific conditions.	168	204	659,019	780,504	1,081,139	1,314,687
Speculation	6	13	23,800	123,600	53,600	406,486
Fraud	88	113	349,802	469,883	1,271,129	1,300,757
Total	1,312	1,401	$5,611,675	$6,420,331	$12,355,282	$13,087,000

Nineteen hundred and twelve was the most favorable in five years in Canada, both as regards failures and liabilities, and there individuals were charged with responsibility for 85.3 per cent of all failures. Lack of capital is the Dominion's besetting business trouble, with 50.3 per cent of all failures charged to it, as against 16.3 per cent due to incompetence, 6.7 per cent resulting from fraud, 5.1 per cent produced by inexperience, and 4.3 per cent attributed to neglect; specific conditions, fraud, speculation, extravagance and competition were less in their effects than in 1911, while the other personal causes were more hurtful. Specific conditions were credited with 12.8 per cent of all failures, as against 14.6 per cent in 1911. As regards liabilities, lack of capital, with 45.8 per cent charged thereto, compares with 47.8 per cent in 1911, and specific conditions were also less hurtful; but incompetence, with 22.8 per cent in 1912, as against 18.9 per cent in 1911, was more hurtful, as was fraud, with 10.3 per cent in 1912, against 9.9 per cent in 1911, and inexperience, with 3.5 per cent in 1912 and 1.5 per cent in 1911.

Fortunately, large corporation breakdowns are infrequent in Canada, with the exception, perhaps, of industrial consolidations, the experience of many of which has not been altogether happy. Disaster is sometimes met, as in the United States, by receiverships and later reorganization. Frequently, as we have already seen, bond and shareholders of companies which have met trouble are called together to face matters, to have their holdings "cut" and to reorganize.

An example of receivership may be cited. In August, 1913, at a meeting of the directors of the Canada Iron Corporation, Limited, it was decided to apply to the courts for the appointment of a receiver. The object

was to obtain a reduction of fixed charges, which was taken to mean that a financial reconstruction would be effected, in which the bondholders would be asked to accept stock in lieu of their secured lien. The bonds are held in England and listed on the London Stock Exchange. The first-mortgage issue was £600,000 of six per cents, but in addition there was a "consolidated" issue of $1,718,000 not listed. There was $2,909,000 of preferred stock outstanding and $4,832,000 of common. No dividends had been paid.

The dumping of United States pig iron into Canada was alleged to have seriously hurt the company's business in 1911 and the first half of 1912, but the last report stated that conditions during the latter half of 1912 and the opening of 1913 were better. In addition to mines and furnaces, the company owned six foundries for production of carwheels, pipes and castings. The directors complained that the abolition of the Canadian pig iron bounty left them at the mercy of United States dumping.

A receiver was appointed and carried on the business of the company pending reorganization. While the application for the receivership was voluntary on the part of the company, it was understood to have been made on the instance of the second-mortgage bondholders, whose interest instalment due had not been paid, and that the bondholders would have a substantial measure of control of the company under the proposed reorganization.

CHAPTER XXX

PRINCIPLES OF REORGANIZATION

262. *Reasons for reorganization.*—There are two general classes of reorganization: first, those that are necessary as the result of insolvency; second, those that prove desirable in order to readjust the securities and the means of control of a company. The principles of reorganization also are somewhat differently applied in railroads and in manufacturing concerns. In order to bring out these distinctions we shall take up in the following chapter three typical reorganizations: First, of an insolvent railroad; second, of a solvent railroad; and, third, of an insolvent industrial. In this chapter our attention will be confined to the general principles which apply in all kinds of reorganizations.

The reasons for reorganization in lieu of a simple sale of property have already been alluded to. In order to make them plain, however, we should give them some further consideration. The complexity of the financial organization of a large corporation is one factor to take into account. In the case of a railroad the parent company will probably own the securities of a number of subsidiary companies. Each one of these subsidiary companies will have one or more mortgages on its line. The stock and perhaps some of the bonds of the subsidiary companies will be owned by the parent company and will perhaps be posted as security for a collateral trust bond issue. The parent company will perhaps own a main line and several branch lines, and will have

outstanding mortgage bonds based on each of the branch lines, mortgage bonds based on the terminals and real estate holdings, and very likely, in addition, a general mortgage bond issue to cover whatever property is left. Then there will probably be preferred and common stock and short-time claims, including accounts payable, accrued wages and bank loans. Such a group of corporate relationships and obligations may be taken as typical. It is, in fact, not half so complex as the financial organization of many large railroad and industrial companies.

In contrast to this complicated financial scheme we find the railroad property to be practically, for operating purposes, an indivisible unit. The word "indivisible," as here used, does not mean, of course, that the property is actually physically merged into one. It would be possible for the branch line bondholders to mark out and segregate their property and take it for themselves; for the terminal bondholders to do the same; for the main line bondholders to do the same; and so on. It is indivisible, however, in the sense that a division of the property would destroy most, if not all, of its value. This statement applies only to a well-constructed, unified railroad system. If any part of the system is superfluous, it may be lopped off and taken by its own bondholders. This, for instance, was the case with the St. Louis and San Francisco Railroad, which was owned by the Atchison, Topeka and Santa Fe, up to the bankruptcy of the latter road in 1893, and was then taken over by the St. Louis and San Francisco bondholders. The same thing was true of the Oregon Short Line, which was temporarily cut off from the Union Pacific system in the bankruptcy of 1893.

Assuming that a failed corporation possesses prop-

erty which is commercially indivisible, the question that arises in case of bankruptcy is, What arrangement can be made to prevent the property from being split up into segments by the conflicting claims of the various security-holders? How can it be held together, put back on its feet and restored to its rightful position as a valuable profit-making business? Every bondholder, as well as every stockholder, is keenly interested in finding the right answer. The value of any bond, as has already been shown, depends in large part on the earning power and prosperity of the issuing corporation.

263. *The formation of committees.*—In the process of getting an answer the first step is to ascertain as nearly as possible the exact status of each of the corporation's obligations. Usually this task is left to the receivers or to such persons as are selected to act as a reorganization committee. Each class of bondholders chooses representatives whose duty it is to represent the interests of that particular class. These representatives are usually called a committee and are selected in various ways. Sometimes a meeting of the bondholders of one class is called and the members of the committee are elected. Sometimes banking houses which have underwritten one or more of the bond issues come forward and offer to serve on reorganization committees. Generally these members of the committee are self-chosen, and are of such character and standing that they readily secure the support of their fellow bondholders. Shortly after the breakdown of a big corporation it is quite customary for one of the heavy bondholders of each class to send a circular letter to the other bondholders of that class stating that they should be represented in the pending negotiations and asking that they place their interests in his hands. Usually he states in the

circular that his only interest in the matter is to secure the rights of the persons to whom he appeals and that he will act in good faith with that sole object in view. The bondholders signify their consent by depositing their bonds with some stipulated trust company. If a majority of the bonds of a given class are deposited, the self-appointed representative or committee is authorized to act on their behalf. We should bear in mind, however, that the committee's authority is only that of a representative. It cannot bind the bondholders to any terms whatever. Whether the bondholders accept the plan which their committee approves or not will depend largely on their estimate of the character and intelligence of the members of the committee.

Within a few days after an important insolvency is announced, there will usually come into existence a number of different duly authorized committees, one representing the general mortgage bondholders, one the bondholders of each of the subsidiary companies, one the debenture bondholders, if there is such an issue, and so on. Ordinarily it is not necessary for the bona fide first mortgage bondholders to organize. They are so well protected that they can afford to sit quiet while the other claimants fight it out. Usually also the stockholders do not organize. They have practically no voice in the reorganization, anyway, if the receivership is unfriendly; if it is friendly their interests are already protected. Sometimes, however, the stockholders as a body, or the preferred and common stockholders, each acting as a class, will appoint committees of their own when burdensome assessments seem imminent.

Once the committees are appointed the "jockeying for position" and the arguments pro and con as to the strength of each of the competing claims on the corpora-

tion's assets begin. If many different claims are involved, it will probably be necessary for the committee of each class of security-holders to appoint a single representative and have these representatives form a general reorganization committee. It is the duty of this committee to discuss terms of reorganization and finally to agree upon a plan which may be submitted to the security-holders.

264. *Why not foreclose.*—The reader may well inquire at this point why the bondholders as a whole or some class of bondholders do not foreclose and sell under their mortgage and thus get enough cash to meet their own claims, or failing that, bid in the property for themselves. It may correctly be suggested in this connection that for the purpose of buying the property when it is sold, each bond would be accepted at its par value.

This question has already been answered in part by the statement in the last chapter to the effect that it would be next to impossible to sell a large corporation to an outsider for cash, because the amount involved is too large. Besides, an outsider who wished to get control of the property could accomplish his purpose much more economically by buying the securities of the failed corporation at the low prices at which they naturally sell during the period of reorganization.

In answering the second part of the question we must consider that the bondholders whose securities are close to the property would not have anything to gain by a sale. Their principal and interest, presumably, are well protected and they could not by any process of juggling get more than principal and interest. With the junior mortgage bondholders the situation is somewhat different. They might at times, if the reorganization scheme appears unfavorable to them, have something to gain

by compelling foreclosure, and bidding in the property. In this case, however, they might be forced to settle all the claims that rank ahead of their own in cash, which would ordinarily be too large an undertaking. However, the possibility of such action on their part is always recognized by the reorganization committee and their claims are in consequence treated with greater respect than they would otherwise command. The result is that foreclosure proceedings are usually only a form. After reorganization plans have been completed foreclosure is simply a method of transferring the property of the old corporation to a new corporation.

265. *Problems confronting the reorganization committee.*—The reorganization committee, then, once formed has a reasonably free hand. At the same time it must act with due circumspection in order not to arouse the hostility of any powerful body of security-holders. It must treat everybody with apparent justice; it must reconcile conflicting claims and interests. The success of whatever plan of reorganization it adopts will depend upon the extent to which the plan is accepted by security-holders. As noted above, the first and perhaps most important duty of the committee, therefore, is to form some working estimate of the relative values of the different classes of securities.

First, they must consider whether there has been an impairment of assets and earnings sufficient to affect the first mortgage bonds. Usually this question may be answered in the negative. If an affirmative answer has to be given, any attempt at reorganization might as well be given up, for nothing can be done except to allow the first-mortgage bondholders to take whatever property is left. Assuming that the first mortgage bondholders are still in an entirely safe position, the re-

organization committee next considers the situation of the bondholders secured by mortgages on outlying or small sections of property. Mortgages of this nature on railroads are usually divisional, terminal, branch line or real estate; with industrial corporations there may be mortgages on unessential plants or property. For instance, a consolidation may originally have taken in twenty plants, and may have found ten of the plants so uneconomical that it has transferred almost all their business to the other ten; or a merchandising corporation may have gone into general trucking; or a paper mill may own a great expanse of forest land, not all of which is essential to its business. In such cases the outlying mortgage bondholders may be allowed to take their property, and their claims may then be eliminated from further consideration. It may well be, on the other hand, that the separate pieces of property so mortgaged are highly essential, in which case the bondholders would be able to insist on a settlement of their claims in full. Thus a railroad could not well get along without its terminals or without equipment, and the reorganization committee would have to allow full value to all bonds based upon such property. A manufacturing corporation may derive its chief profits indirectly from its control of the sources of raw materials, in which case the reorganization committee would arrange to pay bonds based on such property in full, even if the property taken in itself were not of great value. Disputes are bound to arise in connection with many of these claims on specific pieces of property.

A railroad branch line, for instance, may earn very little revenue for itself, according to the railroad's method of figuring, and may have absolutely no value except as an adjunct to the failed railroad. Yet it may

turn over to that railroad a large and highly profitable traffic. The bondholders will naturally point to this traffic as justification for a demand that their claims be paid in full. The other interests involved will point to the isolated position of the branch line apart from the railroad as sufficient ground for attaching very little value to the branch line bonds. Usually a compromise is necessary. Both parties have much to lose and nothing to gain by a permanent separation of main and branch lines. Each side will probably "bluff" so far as it dares, and each will finally concede something.

The reorganization committee next takes up the claims of the general mortgage bondholders and endeavors to ascertain how much assets and earnings are left for them after satisfying prior claims. This may or may not be a particularly difficult task; that all depends on the nature and complexity of underlying mortgages. The value of the general mortgage bonds will depend to a great extent on the wording of the mortgage. It may cover only such property as was in existence when the mortgage was drawn or may contain an "after-acquired property" clause. Next in order of consideration are the debenture bonds. As these bonds are chiefly claims on earnings, not on assets, the reorganization committee in estimating their value will try to find out how much of the corporation's income is left for them after paying prior interest charges.

Finally, the reorganization committee will consider what must be done for the preferred and common stockholders. Sometimes in heavily over-capitalized concerns the common stock will be wiped out absolutely. It is more usual, however, to try to preserve something for

the stockholders, with the proviso, usually, that the stockholders pay certain cash assessments.

266. *Necessity for cash.*—Another factor in reorganization not previously mentioned is the current or floating debt of the corporation. This debt may take the form either of loans and medium-term notes having specific security or of unsecured obligations, such as accounts payable. Whether secured or unsecured, this floating debt must be paid in cash; otherwise the creditors of this class will certainly attach the assets of the corporation and effectually prevent the success of reorganization. The only path of escape from the floating debt would be through foreclosure and sale of the property, and this path does not lead to reorganization. The reorganization committee, therefore, must by some means raise cash sufficient to meet all this floating debt in order that the reorganized company may begin business. Furthermore, there must be enough cash left over to provide the reorganized company with a fair working capital; otherwise it will begin at once to get into new difficulties, as is well illustrated by the career of the Detroit, Toledo and Ironton Railroad reviewed in the last chapter. The committee also, if it desires to have the reorganized company prosper, must see to it that its fixed charges are not larger than its minimum net earnings. We have thus, four main objects of every reorganization: (a), to pay the floating debt; (b), to provide working capital; (c), to bring the property up to at least normal efficiency; (d), to reduce fixed charges below minimum earnings.

The first three of these objects require cash in large amounts; especially is this true since a company which is approaching insolvency almost always lets its accounts payable accumulate, its working capital decline,

and its property become impaired. Of course, this may not be the situation at all if the corporation has simply met with some temporary reverse, which brought it into a condition of legal insolvency. In such a case the problems of reorganization are comparatively simple. As a general thing, however, the reorganization committee will find it necessary to raise cash from every available source. As sufficient cash makes the attainment of the first three objects named above easy, we may say that the reorganization committee will consider two things of prime importance: first, to raise cash; second, to reduce fixed charges.

267. *Raising cash by assessments.*—There are three possible methods of securing cash; first, by the sale of some of the corporate property; second, by the issue of new securities; third, by assessments on the security-holders. The first method is almost never practicable. If the corporation possesses outlying property non-essential to its business, it is more than likely that this property has been heavily mortgaged and must be turned over to the mortgagees. The second method, as a general thing, is equally impracticable. Obviously a corporation is not likely to fail unless it has already exhausted its borrowing power, and the sale of the stock of an insolvent corporation is out of the question. These considerations again do not necessarily apply when the corporation is not a true insolvent but has merely suffered a temporary setback. Even in true insolvency cash is sometimes raised through considerable issues of receivers' certificates, which in reorganization are funded along with the first mortgage bonds into a new first mortgage issue. At times this may be entirely proper and expedient. The efficiency of the corporation's assets may have become impaired and a

little cash raised by receivers' certificates may put them into such a condition as to enhance its earning power vastly more than the amount of the extra fixed charges thus imposed.

The third method—assessment on the security-holders —is almost universal. Naturally the first and heaviest assessments fall on the common and preferred stockholders. The possibility of raising cash by this method is limited by the stockholders' estimate of the value of the stock of the reorganized company. They are given the choice either of paying the assessment or of forfeiting their equity in the corporation's assets. If the assessment is made too high evidently the stockholder will choose to forfeit whatever rights remain to him, rather than to pay what is asked. The reorganization committee will therefore endeavor to keep the assessment down to what it considers a reasonably low figure.

Under these conditions the average stockholder almost always finds it worth while to pay his assessment and retain an interest in the company. If he cannot raise the necessary cash he will sell his stock in the open market for whatever it will fetch to someone who has both the courage and the means to meet the assessment. It is almost always true that the stock of a failed company sells at an abnormally low figure. It is frequently true that a short time after reorganization, the stock of the reorganized company sells at a price considerably above the price of the old stock during the receivership plus the assessment. In other words, experience has demonstrated that the stockholder will do better if he sticks with the company than if he forfeits or sells his shares. By paying the assessment he reduces his losses.

Sometimes, although rarely, it becomes necessary to

assess the junior bondholders also. It seems strange that a creditor of the corporation should ever be forced to pay an assessment in order to remain a creditor, yet the logic of the situation compels the bondholders, when they are thus assessed, to accept it with as good grace as they can muster. The bondholders will not and cannot equitably be compelled to pay unless the burden is too heavy for the stockholders to carry alone. If the amount of cash needed is so large that most of the stockholders would rather lose their equity in the property than furnish their proportion of the cash, the bondholders find themselves in an unpleasant dilemma. Either they must take some of the burden off the stockholders' shoulders, or they must take the whole burden themselves and eliminate the stockholders altogether. Almost always they prefer the former alternative. When the Atchison, Topeka and Santa Fe Railroad, for instance, was reorganized in 1894, the cash requirements were so large that each stockholder would have been compelled to pay in the neighborhood of $14 per share, and it was more than doubtful if the stock of the reorganized company was worth this amount. The reorganization committee, therefore, imposed $4 of the assessment on the junior bondholders.

Usually the cash needed by the company is not required at once, and the terms of payment of the assessments may therefore be made fairly easy, thus reserving some of the cash resources of the corporation. Another means of providing funds for future use is to base the bond issues of the reorganized company on a limited open-end mortgage, so that the company need not be hampered for many years to come by a dearth of funds.

268. *Reducing fixed charges.*—Having provided the

reorganized company with sufficient cash, the reorganization committee now takes up its final and most difficult problem, reduction of fixed charges. The fixed charges that may be affected are of three kinds: guarantees, rentals and interest. A company may be dissolved in reorganization, in which case it is, of course, released from its previous contracts and the reorganized company may or may not renew them. If guarantees of interest and dividends on subsidiary company securities have proved burdensome and unprofitable, the reorganization committee has an opportunity to dispense with them. It does not follow that the committee will always take this action. The guarantee may be necessary in order to hold control of the subsidiary companies. Frequently, however, the holders of the guaranteed stock and bonds will submit to a reduction of the guarantee rather than take back their property.

Much the same thing may be said of rentals. The owners of a leased property would ordinarily have great difficulty in leasing it to any other corporation and could not very well operate it themselves. Especially is this true when the leased property has been constructed in the interest of the failed corporation. The owners, therefore, have practically no choice in the matter. They must submit to any reasonable reduction that the reorganization committee demands.

Far more important usually in its effect on fixed charges is the substitution for the interest-bearing securities of the old corporation of dividend-paying securities of the new corporation. Sometimes, also, old securities which bear interest at a high rate are converted into new securities bearing interest at a low rate. The result of this readjustment, if the reorganization is to prove suc-

cessful, must be to bring the total fixed charges below the net earnings of the corporation even in the worst years. Ordinarily the reorganization committee will first make a conservative estimate of the lowest earnings likely to occur in the future and will cut down interest charges accordingly. Of course this reduction is not proportionate on all the bond issues, but is adjusted in accordance with the relative strength of the various claims against the corporation, as already indicated.

One of the great advantages of reorganization is the possibility which it affords of unifying and simplifying the complicated and sometimes conflicting obligations that have been imposed at various times. The reorganization committee will usually arrange for a few comprehensive, well-defined mortgages in place of the numerous mortgages previously existing and will increase the amount authorized under each mortgage. This principle, however, cannot be extended too far. The committee cannot, for instance, without getting into legal difficulties, absorb any of the old bond issues, interest on which has unquestionably been earned for several years previous. The old first mortgage issue and the first mortgage bonds on highly important specific pieces of property will therefore generally be left untouched. On top of them, however, the committee may impose a new general mortgage bond issue of large size sufficient to refund all the existing issues that are to be absorbed, to refund the old first mortgage bonds when they finally fall due and to provide for necessary improvements and extensions. This general mortgage issue will be designed evidently to become in time a first lien on all the corporation property. For these new general mortgage bonds the old

junior bonds will be exchanged on such terms as may be finally agreed to.

269. *Capitalization of the reorganized corporation.* —Assuming that the reorganization committee has succeeded in determining the relative values of the various issues of mortgage bonds, it may now proceed to a corresponding allotment of the new general mortgage bonds. Suppose, for instance, that there had been outstanding $1,000,000 second mortgage bonds, $500,000 branch line bonds and $1,500,000 debenture bonds and that the new general mortgage issue available for exchange is fixed on the basis of the lowest earnings at $2,000,000; suppose also that the reorganization committee estimates the first-named issue on the basis of lowest earnings to be worth 80 per cent of its par value, the second-named issue, 60 per cent, and the third-named issue, 60 per cent: It would then offer to the bondholders of the first class $800 in new general mortgage bonds for each $1,000 of the old bonds, and to the bondholders of the second and third classes, $600 in the new bonds for $1,000 of the old bonds. As the values of the old issues and the amount of the new issue are figured on the same basis, lowest net earnings, they must, of course, exactly correspond. Not every case is so simple by any means, as our illustration. The same principle, however, would always be applied.

It is felt to be equitable, as well as necessary in order to satisfy the bondholders, that they should be compensated for the reduction of their interest-bearing principal. This is accomplished by giving them at least enough dividend-paying principal to bring the par value of their holdings in the reorganized company up to an equality at least—sometimes considerably more than an equality—with the par value of their old secur-

ities. Formerly it was customary to give them the difference between the par value of their old bonds and the par value of their allotment of new interest-bearing bonds in the form of income bonds. Income bonds have already been described and characterized. They are a fallacy and a delusion and at the present time are practically unused. Their place in reorganization has now been taken by preferred stock. The debenture bondholder in our illustration who got $600 in new bonds for $1,000 in old bonds would under the present practice probably get also at least $400 in preferred stock. He thus has a chance to share in the future prosperity of the company. He may well hope and even expect that in the end he will more than recover his losses. The same principle is applied to all the other bondholders, so far as practicable, and even to the preferred and common stockholders. It follows that one usual and almost necessary result of a reorganization is a great increase in capitalization. The reorganization committee endeavors to remedy the failures and disappointments of the past and present by drawing heavy drafts on the future. It is only fair to say that in this country these drafts have usually sooner or later been honored.

The final problem which the reorganization committee must settle is whether to revive the old company and the old charter or to take out a new charter and organize a new company. The first course involves a maintenance of all the previously existing contracts and obligations of the company not provided for in the reorganization scheme. Its advantage, of course, lies in the retention of the charter which may perhaps confer valuable privileges. The question is at bottom legal rather than financial. In truth, it is a matter usually of no very great consequence.

To insure stability of financial mangement, until after the reoganized company is well started, it is not uncommon to place the new stock in the hands of a voting trust for a period of years. The nature and operations of such a trust have already been described.

270. *Summary of the chapter.*—Briefly the principles and the results of reorganization may be summed up as follows:

(a) The reorganization must remove the immediate causes of bankruptcy by providing cash and at the same time reducing fixed charges.

(b) The reduction of securities bearing fixed charges may well be and usually is accomplished by a great increase of dividend-paying securities.

(c) In determining who shall stand the losses caused by the company's insolvency, the reorganization committee will first rank the securities in the order of their safety and will then impose the losses in inverse order.

(d) In so doing the directors must of necessity consider primarily the ability of the security-holders to make trouble for or to wreck the reorganized company if their demands are not satisfied.

(e) In raising necessary cash they will naturally impose the first and heaviest assessments on stockholders, but they must bear in mind that if they go beyond certain limits the stockholders will forfeit their shares rather than pay the assessments.

The working out of these principles will be further discussed in connection with the illustrations cited in the following chapter.

CHAPTER XXXI

THREE TYPICAL REORGANIZATIONS

271. *Growth of the Santa Fe System.*—The principles of reorganization laid down in the preceding chapter will be much better understood if we consider their application in a few typical instances. For this purpose we will take, first, the forced reorganization of the insolvent Atchison Topeka and Santa Fe Railroad Company in 1894; second, the voluntary reorganization of the prosperous Chicago, Rock Island and Pacific Railway Company in 1902; third, the forced reorganization of the Westinghouse Electric Manufacturing Company in 1908.

It is necessary to go back several years in order to get a typical case of a large railroad receivership and reorganization, for American railroads in the last fifteen years have enjoyed extraordinary, and up to 1907 almost uninterrupted, prosperity. It is true that a considerable number of railroad systems, including the Seabord Air Line, the Chicago Great Western, the Detroit, Toledo and Ironton, the Chicago, Cincinnati and Louisville, the International and Great Northern, the Western Maryland and the Macon and Birmingham went into the hands of receivers as the result of the financial panic of October, 1907. None of these roads, however, is of first-rate importance and their problems did not prove as intricate and difficult as the problems of the numerous railroad reorganizations following the great crisis of 1893. We shall find it therefore more

instructive—even if not of so great current interest—to study one of the 1893 reorganizations rather than one of later date.[1]

Like most of our great railroad systems, the Atchison, Topeka and Sante Fe has grown by leaps, so to speak. It was chartered in Kansas in the year 1863, and construction on the first section of the road was begun in 1869. The main line from Kansas City to Colorado, thence in a southerly direction to Albuquerque, New Mexico, and thence southwest to a connection with the Southern Pacific Railroad at Deming, Arizona, was not completed until 1881. In 1882 the Atchison exchanged its stock for the stock of the Sonora Railroad, and thus secured an entrance of Guaymas, Mexico. The company by using a section of the track of the Southern Pacific had a through route from Kansas City to the Pacific Coast. To appreciate the importance of reaching the Pacific Ocean it must be borne in mind that traffic from any of the Pacific Coast ports may move readily and cheaply by water to any other of these ports. The Santa Fe was therefore in a position to take through business by its part-water-and-part-rail route from any point on the Pacific Coast to the East.

This route, though important, could not, however, bring to the Santa Fe a large proportion of the traffic to and from the Pacific Coast in the face of the existing competition of the all-rail routes, particularly of the Santa Fe's chief competitor, the Southern Pacific. President Strong of the Sante Fe therefore entered into

[1] Acknowledgment should be made here, in connection with the following reviews of the Santa Fe and Rock Island reorganizations, of the information obtained from Mr. Stuart Daggett's "Railroad Re-Organization." Most of what follows as to these two companies is based on Mr. Doggett's researches. He is one of the first to bring to bear on financial problems the thorough, scientific methods of university scholarship.

an alliance with the St. Louis and San Francisco Railroad, which owned the charter of a company known as the Atlantic and Pacific Railroad Company. By the terms of this alliance the two roads jointly financed the operations of the Atlantic and Pacific and by means of purchase and of new construction endeavored to secure a through rail route to San Francisco. In 1885—one of the great railroad building years of the United States—the Atchison, by construction, purchase and lease combined, managed to reach Los Angeles. The main line of the road still had its eastern terminal, however, at Kansas City and the system did not reach the Gulf of Mexico, or in fact any of the rapidly developing agricultural country south of Kansas. To remedy this defect a road, known as the Gulf, Colorado and Santa Fe, had been constructed, partly in the interest of the Santa Fe, from Galveston to a point about two hundred miles north, and another line known as the Southern Kansas Railroad was built south from Arkansas City to connect with the track of the Gulf, Colorado and Santa Fe. In 1886 the stock of the last-named road was bought by the Atchison and the bonds, to the extent of about $17,000 per mile, were assumed. In 1887 the Atchison purchased the Chicago and St. Louis Railroad between Chicago and Streator, Illinois, and other subsidiary companies constructed new track up to Streator. By 1888 it had thus obtained its Chicago entrance.

In the meantime between '86 and '89 it had built a large number of branch lines in all directions largely for the purpose of forestalling competition. "The method of financing these competitive extensions varied," says Mr. Daggett. "Sometimes the parent company guaranteed the principal and interest of the

branch line bonds; sometimes it took these into its treasury and issued collateral bonds against them; sometimes, perhaps more frequently still, it leased new roads for a rental equivalent to the annual interest on their bonds. If the branches could have earned their fixed charges, the burden of the Atchison would have been nominal, but as in large part they could not, it was real and serious."

The results of the rapid expansion of the Santa Fe from 1884 to 1888 are well summarized by Mr. Daggett in the following table:

	1884		*1888*
Mileage	2,799		7,010
Bonds	$48,258,500		$163,694,000
Stock (Atchison)	60,673,150		75,000,000
Gross earnings	16,699,662		28,265,339
Operating expenses	9,410,424		21,958,195
Net earnings from operation	7,289,237		6,307,145
Net profits excluding dividends	5,147,883	def.	2,933,197
Net profits, including payments for dividends and interest on floating debt		def.	5,557,323

It should be noted that while the bond indebtedness (including the assumed bonds of subsidiary companies) had considerably more than tripled, gross earnings had increased only about 70 per cent and net earnings from operation had declined. Evidently, unless this tendency should be speedily reversed, the company was doomed to insolvency. In addition the floating debt had increased from approximately $3,300,000 in 1884 to over $8,000,000 in 1888, and the road had consequently been forced to authorize, in October, 1888, $10,000,000 of three-year notes.

272. ***First reorganization of the Santa Fe and its results.***—The situation was so obviously dangerous that a committee of the directors was appointed in 1889 to bring about a friendly reorganization and thereby to avert bankruptcy.

About one-third of the $163,000,000 of bonds were direct obligations secured by mortgages on the Atchison's own property, while the other two-thirds consisted of obligations of thirty-two subsidiary companies. From what has been said in the preceding chapter, it will be seen that the entanglements and conflicts of these various issues were almost beyond unraveling. The directors first aimed at simplification and with that object in view suggested that two large issues be put forth, one of 4 per cent general mortgage bonds, to the amount of $150,000,000, and one of 5 per cent income bonds to a total of $80,000,000. Some $14,000,000 were to be sold in order to raise necessary cash and the remainder of the two bond issues was to be exchanged for the numerous existing issues. Income bonds were much used in reorganization at that period and were not received with the distrust which they now excite. The proposal to the original bondholders that they should exchange their mortgage bonds in part for income bonds was not, of course, altogether palatable; yet it must be remembered that the bonds which were to be thus exchanged had always been regarded as more or less speculative in character and had for that reason been sold, for the most part, well below par, and, furthermore, that the branch line bondholders would have lost rather than gained by a forced bankruptcy and foreclosure sale. Moreover, the basis of the exchange was such as to compensate them in part for their loss of fixed interest payments by a larger principal. In other

words, as usually happens in reorganizations, the company proposed to cut down its current fixed charges and held out in place thereof hopes of high optional payments in the future. The reorganization plan was accepted and put into effect.

After this reorganization, the Atchison policy of rapid expansion was apparently renewed with fresh vigor. In 1890, by an exchange of securities, the St. Louis and San Francisco Railroad was brought into the Atchison system. This acquisition of 1,300 miles at one stroke did not prove nearly as profitable as was anticipated. In the same year the Colorado Midland 346 miles long, was purchased.

When the $10,000,000 note issue of 1888 fell due in 1891, the directors found themselves unable to meet the payment out of earnings and therefore arranged for a two-year extension. In 1892 the need of additional funds for improvements and extensions, which, as the reader may have noted, had not been at all provided for in the reorganization of 1889, made necessary a new issue of second mortgage bonds. As the terms of issue of the $80,000,000 income bonds forbade any prior lien (except the first mortgage) being placed upon the property, it was necessary before placing a second mortgage to arrange for the protection of the income bondholders. This was accomplished by making the second mortgage cover an issue of $100,000,000 4 per cent bonds, $80,000,000 of which were to be exchanged dollar-for-dollar for the income bonds, and $20,000,000 to be sold for cash. Thus in 1893, by a coincidence, which may be called unfortunate, but which with wise management would never have occurred, the Atchison had to face largely increased fixed charges and the payment of the $10,000,000 note issue, both coming at the same time

with the panic and the traffic losses of that disastrous year. In January, 1894, the inevitable insolvency arrived.

273. *Second reorganization and its results.*—Several bondholders' committees, according to the custom in reorganization, were quickly formed. Among others the English holders of second-mortgage bonds sent over a strong committee which put forward what was known as the English plan of reorganization.

This plan involved foreclosure either by the first or second mortgage bondholders. In either case the first mortgage issue would be left undisturbed and overdue interest would be paid either in cash or in new securities. A new income mortgage bond issue was to be exchanged for the second mortgage bonds and was also to provide compensation for an assessment of $12 per share on the stockholders. By paying this assessment the stockholders would retain their stock interest in the road, as well as receive income bonds. The income bonds were to have voting power. The substance of the plan, it is evident, was to reverse the former conversion of income bonds into second mortgage bonds. In the reconversion the English bondholders were to secure an increase in principal and the important privilege of voting. The plan was not acceptable to the stockholders, however, who felt that part of the load thus imposed upon them ought rightfully to be borne by the second mortgage bondholders.

Before the argument had been carried far a new factor was introduced into the situation, namely, the publication of the report of Mr. Stephen Little, an expert accountant who had thoroughly investigated the Atchison books. Mr. Little found that by means of peculiar fictitious accounts—most important of which was an ac-

count that carried rebates by the company as an asset—the recorded earnings of the railroad had been deliberately inflated. The annual net earnings, according to the company's reports, had been as follows:

1891	$ 7,631,598
1892	10,953,896
1893	12,126,866

According to Mr. Little they should have been:

1891	$ 5,204,880
1892	7,853,173
1893	8,085,608
1894	5,956,615

This startling anouncement completely changed the plans which had been formulated. It was evident that a far more radical reduction of fixed charges would be essential.

A new committee proposed the second and final reorganization plan in March, 1895. The purposes of this plan were stated to be:

(a) To reduce fixed charges to a safe limit;
(b) To provide for future capital requirements;
(c) To liquidate the floating debt;
(d) To reinstate existing securities upon equitable terms in the order of their priority;
(e) To consolidate and unify the system.

The committee proposed foreclosure under the first mortgage and the formation of a new railway company which was to issue

(a) Common stock	$102,000,000
(b) 5 per cent. non-cumulative preferred stock	$111,486,000

(c) General 4 per cent bonds............$96,990,582
(d) Adjustment [1] 4 per cent bonds.......$51,728,310

Old common stockholders were to receive share for share new common stock provided they paid an assessment of $10 per share and for this $10 were to receive $10 in new preferred stock. An underwriting syndicate guaranteed to take the place of defaulting stockholders. The old general mortgage bondholders were given 75 per cent of their holdings in new general mortgage bonds and 40 per cent in adjustment bonds. The second-mortgage bondholders were to be assessed $4 for every $100 of their holdings and were to receive 113 per cent in new preferred stock. It was provided that additional bonds under the general mortgage might be issued at the rate of $3,000,000 per year up to a limit of $30,000,000 and that thereafter additional adjustment bonds might be issued at the rate of $2,000,000 per year up to a limit of $20,000,000.

The St. Louis and San Francisco Railroad and some other smaller subsidiary lines were not included in the reorganization plan, but were turned over to their own bondholders.

It will be seen that this plan accomplished the five purposes named by the committee. It brought about a very radical reduction of fixed charges affecting even the first mortgage bondholders. It gave room for additional issues of bonds under certain restrictions to provide for future improvements and extensions. It brought in about $14,000,000 cash to meet current obligations. It retained the relative claims of the various security-holders to the road's assets and earnings. Finally, by lopping off nonessential lines, it helped to consolidate and unify the system.

[1] The so-called adjustment bonds were in reality income bonds.

The principal opposition to the plan came from some of the minority stockholders who believed that the former management had proved untrue to their interests and that this management had not been entirely eliminated. This opposition, however, was unable to muster enough votes to defeat the reorganization plan

The high credit and prosperity of the Atchison in the last few years indicates that the reorganization was carried through on sound lines. There has never been a question raised since the reorganization but that the company could easily meet all its obligations. The road has been greatly improved and strengthened physically and earnings have grown far more rapidly than expenses. The changes in the decade following 1897 are shown in the following tabulation:

	1897	*1907*
Mileage	6,479	9,273
Gross earnings	$30,621,230	$93,683,407
Net earnings	7,754,041	32,153,692
Annual surplus	1,452,446	21,168,724

Naturally the market price of the Atchison securities has steadily risen. Nobody suffered in the end from the reorganization. On the contrary, all the security-holders who retained their interests have seen them steadily appreciate in value. The Atchison reorganization of 1895 may well be taken as a fair type of a highly successful readjustment of charges.

274. *Growth of the Rock Island System.*—We will consider now an entirely different kind of reorganization—one in which not necessity but desire for quick speculative profits was the controlling factor. In order to understand the situation it will be well to review hastily the history of the Rock Island Railroad. The line was completed between Chicago and Rock Island in 1854,

and from Rock Island to Council Bluffs in 1869. The company was prosperous almost from the beginning. Its road ran through a well-settled and fertile territory where traffic was large and certain and construction was cheap. Capitalization was very moderate, especially as compared with many other western railroads whose construction was paid for not in cash but in extravagant allotments of stocks and bonds to the contractors. In 1880 the road was earning so much and paying such large dividends that it seemed desirable to water the stock. This was accomplished by an exchange of the stock of the Chicago, Rock Island and Pacific Railroad Company for the stock of a new Chicago, Rock Island and Pacific Railway Company in the ratio of about two to one The new Railway Company also took in some other properties previously controlled by the Railroad Company, and was, therefore, in form, though not in fact, a consolidation.

The new railway company did not continue to be as prosperous as it was in the beginning. The middle '80s were hard years for western railroads, for all of them were forced into competitive railroad building, which for the time being was largely unprofitable. The Rock Island dividends and the market prices of the road's securities suffered severely. Nevertheless, the road's management was conservative and able and the company not only survived, but even paid dividends through the trying depression of 1893-1897. After 1897 the road shared in the renewed prosperity of the United States and began in its conservative way to plan for further expansion and development.

In 1901, however, the conservatism of the company suddenly disappeared as if the earth had swallowed it. Directors and officers who had served for years and dec-

ades were removed, and new men—younger men of an entirely different type—were put into their place. With the older men there vanished also the former ideals and purposes of the company and a very different path toward success and prosperity was entered.

The reason for these changes is to be found in the fact that during 1900 and 1901 a small coterie of speculative promoters known as "the Moore crowd," of whom we have heard in connection with the formation of the United States Steel Corporation, had quietly bought a majority of the common stock in the Wall Street market. The process of buying had been carried on so patiently and warily that it was hardly suspected and the price of the stock was very little increased. The financial world first got an inkling of the situation when in April, 1901, Mr. William H. Moore and Mr. D. G. Reid were elected to the directorate.

The principal men in the new party, which now rapidly assumed full control of Rock Islands affairs, were Mr. W. H. Moore, his brother Mr. J. H. Moore, Mr. D. G. Reid and Mr. William B. Leeds. No one of these men had had any experience in railroad managerial positions and none of them had ever been prominently identified before with railroad operations. All of them, however, were bold and successful speculative promoters and all of them were well versed in the ways and wiles of the speculative security market. Their successes had been gained in the promotion of the companies which were taken into the United States Steel Corporation. Their interest in railroad affairs, therefore, it was easy to see, was entirely financial. They did not take, and as a matter of fact never have taken, any active part in the operating management of their road. All their energies have been given to maintain-

ing its financial status and at the same time directing for their own benefit its financial operations.

In the two annual meetings of June, 1901, and June, 1902, the stockholders increased their capital stock from $50,000,000, at which it had been placed in 1880, to $75,000,000. Also the stock of some smaller roads, including the important Choctaw, Oklahoma and Gulf, was bought by the Rock Island, payment being made partly in cash and partly in Rock Island securities.

275. *Rock Island reorganization.*—The "Moore crowd" now brought forward the scheme of reorganization which they had devised primarily, it appears, with a view to selling a large part of their stock without losing control. The plan involved two holding companies and a double exchange of securities. It is perhaps the most complex and ingenious scheme on a large scale for attaining the purpose just named that has yet been successfully put through.

The operating company under this scheme remained the same as it had been since 1880, the Chicago, Rock Island and Pacific Railway Company. The first holding company (whose prime object, apparently, was to meet any legal objection that might afterwards arise to the consolidation of competing railway companies) was the Chicago, Rock Island and Pacific Railroad Company, incorporated in Iowa. The second holding company was the Rock Island Company, incorporated in New Jersey. The outstanding bonds and other securities of the old "railway" company were left undisturbed. The new "railroad" company issued stock to the amount of $75,000,000. The Rock Island Company issued $96,000,000 common and $54,000,000 preferred stock. The last-named company then delivered $127,-500,000 of its preferred and common stock to the Chi-

cago, Rock Island and Pacific Railroad Company of Iowa in exchange for all the $125,000,000 common stock of the Iowa company. After this transaction the last-named company had in its treasury most of the common and preferred stock of the Rock Island Company; it also had the right to issue $75,000,000 bonds. It now offered for each share of the railway company's stock, one share of its own 4 per cent bonds, one share of Rock Island Company common stock and $70 of Rock Island Company preferred stock. These bonds were to be collateral trust secured by the deposit of all the "railway" company shares obtained by the "railroad" company. Thus the "railway" stockholders would, in case of default, get back exactly the stock which they had exchanged.

The "railway" stockholders readily accepted this proposition, which was equivalent to giving a large stock dividend, and figured that even if they retained in their own hands all the securities which they received by the exchange they could not lose and might benefit by the exchange. If they did not care to retain all the securities they received, they could easily dispose of their Rock Island common and preferred shares and thus get a large immediate cash payment.

We shall understand better why the "Moore crowd" desired this reorganization if we examine the charter provisions of the Rock Island Company. One of the important clauses reads as follows:

> There shall be five classes of directors. The first class shall contain a majority of the whole number of the directors as fixed at any time by the by-laws. The holders of the preferred stock shall have the right to the exclusion of the holders of the common stock to choose directors of the first class.

Thus a majority of the Rock Island Company preferred stock could elect a majority of the board of directors of that company and this board, through the company's holdings of "railroad" stock could completely control all the affairs of the Chicago, Rock Island and Pacific Railway Company, the operating company. Now the outstanding preferred stock of the Rock Island Company is only a little over $45,000,000; therefore the ownership of approximately $22,500,000 par value of this preferred stock would be sufficient to give complete control over the whole Chicago Rock Island and Pacific Railway Company, having a total capitalization of about $225,000,000. Indeed, if this $22,500,000 preferred stock were carried on a margin of $20 a share, $5,400,-000 cash would suffice to secure control.

The advantage of this reorganization to the "Moore crowd" may readily be seen if we compare the price they paid for control in the "railway" company with what is necessary for control in the Rock Island Company. Assuming that they bought all their stock outright and paid in the neighborhod of 140, which was not far from the average market price while they were buying control of the "railway" company, their investment would have been $52,500,140. In exchange for this under the reorganization scheme they obtained stock and bonds which at the market prices of the early part of 1908 were worth:

Rock Island Company common	$18,375,049
Rock Island Company preferred	21,918,808
Chicago, Rock Island & Pacific Railroad Co. 4% bonds	32,765,712
Total	$73,059,569

As the preferred stock was all that was necessary for control, they were left free to sell their bonds and common stock, and it will be observed that this sale would have brought to them just about as much cash as they had originally paid for control of the Chicago Rock Island and Pacific Railway Company. In other words, control of the Rock Island Company, carrying with it control of both subsidiary companies, cost them in cash next to nothing.

In addition, the Rock Island Company later obtained control of another great railroad system, the St. Louis and San Francisco. The Rock Island directors accomplished this by offering to exchange for each share of common stock of the St. Louis and San Francisco \$60 par value in the common stock of the Rock Island Company and \$60 par value in a new issue of 5 per cent gold bonds, the bonds being secured by deposit of the "Frisco" common stock as collateral. It will be observed that this great addition to the Rock Island system did not disturb in any way the controlling force of a majority of the relatively small issue of Rock Island Company preferred stock. Thus by reorganization and purchase the "Moore crowd" with a very small expenditure of cash, have under their control a system with an aggregate mileage of 14,270 miles.

276. *Westinghouse reorganization.*—This reorganization of 1908, although not essentially different in principle from the Santa Fe reorganization, introduces some new features that are worthy of attention. Owing to space limits it is necessary to confine our attention to these peculiar features.

This is a typical instance of a company which was strong in equipment and ability and which was doing a large and profitable business and yet suddenly found

itself technically insolvent. Its difficulties resulted from a lack of sufficient working capital. The company's assets were too largely fixed, and quick assets were relatively too small, considering the amount and character of the company's business. In prosperous times the company was able to prosper with the rest of the country. In the period of strain, however, it was very quickly stripped of cash and, being unable to obtain capital, necessarily went to the wall.

It naturally followed that the most active and influential body of creditors in planning the reorganization were merchandise creditors; next to them came the bank creditors; the bond and note holders were little consulted and their claims were not disturbed.

The problem before the reorganizers of this company differed from that which confronts most reorganizers in that the company needed simply to be tided over a bad period. No one apparently felt any question as to the renewed prosperity of the company as soon as normal business conditions should be restored. The permanent fixed charges were met even during the period of reorganization. All that was necessary, therefore, was to take care of the floating debt.

The main elements in the floating debt were notes payable to banks, $7,919,000, and merchandise debts, $4,762,000. After much discussion and consideration of two or three plans, the merchandise creditors, through their committee, finally agreed to accept new common stock of the company at par in full settlement of their claims on certain conditions specified below:

(a) Such of the bank debt as would not accept new common stock to be provided for partly by convertible bonds of an issue already authorized previous to the

bankruptcy and partly by 5 per cent notes running for an average period of 5 years.

(b) The existing issues of convertible bonds, debenture certificates and collateral notes not to be disturbed.

(c) The preferred and common stockholders each to pay a 25 per cent assessment in cash.

It will be observed that none of the sacrifices under this plan were to be made by the bond and note holders. Indeed, it would have been impossible to impose sacrifices upon these classes or to refuse or modify their claims, for in that case they would certainly have been prompt to bring foreclosure proceedings, buy the property at a forced sale and thus reduce the unsecured claims and wipe out the stockholders. The bond and note holders, in other words, were in an impregnable position because the company, even in the worst times, was more than earning the permanent fixed charges.

The bank creditors came next in order of preference, and their only loss, therefore, was an extension of time of payment of their obligations. The unsecured creditors, knowing the weakness of their position, were willing to accept stock in payment. Under the circumstances it was both expedient and just that the stockholders should be called on for particularly heavy assessment. It was expedient because the prospects of the company were excellent and the stock, even through the reorganization, sold at fairly good prices. The stockholders, therefore, could well afford to pay this assessment rather than forfeit the stock. It was just that they should pay because the difficulties of the company could have been prevented if less had been paid out in dividends and more cash had been reserved for an emergency. Such protests as were made by the stockholders for these

reasons proved unavailing and the plan as outlined above has been carried into effect.

The company operating under this plan has re-established itself as a firm and prosperous corporation. There was no reason to fear the result. The plan provided for all the floating debt incurred before the reorganization, it enlarged only very slightly the fixed charges of the company, and it introduced new and conservative elements into the management of the company. The cash working capital on hand after reorganization was sufficient for the needs of the next two years, even if business had been very poor indeed. In addition it was at once clearly stated on good authority that dividends on the new common stock of the company would not be paid for at least two years, thus giving time for the accumulation of a substantial surplus. These drastic measures proved effective in strengthening the company's financial position and enabling it to go forward steadily, almost as if no setback had occurred.

CHAPTER XXXII

CANADIAN REORGANIZATIONS

277. *Canadian reorganizations and sacrifice of securities.*—Several reorganizations of important Canadian corporations have already been discussed in this volume. Competent financial authorities, both in Canada and Great Britian, have hinted that company reorganizations in the Dominion have been too numerous and that primary financing should be effected with such monetary modesty as will increase the safety of all the securities, especially the bonds. Bondholders and shareholders of several corporations have undoubtedly had to sacrifice a considerable portion of their holdings in order to see *proposed reorganization schemes effected.* Almost every prominent financial visitor from Great Britain, from whence so much capital is obtained for Canada, issues a warning on this point and also on the evils of over-capitalization. These are matters which demand the serious attention of Canadian financiers.

278. *Two Canadian reorganizations.*—We may briefly examine the reorganization schemes of two Canadian corporations. The Canadian Cereal and Milling Company, which at one time was a part of the International Milling Company of Moose Jaw, found it necessary to reorganize in 1912. A new company, the Canadian Cereal and Flour Mills, Limited, was formed. Additional working capital was obtained by means of the issue of $250,000 seven per cent cumulative preferred

stock. The new company was given the following capitalization:

Stock	Authorized	Issued
Preferred	$2,000,000	$ 750,000
Common	2,000,000	750,000
	$4,000,000	$1,500,000

This compares with $8,000,000 capital of the old company, the assets of which have now been transferred in consideration of $500,000 preferred shares of the new company. The ordinary shares were used as a bonus to the underwriters in consideration of their taking $250,000 of preferred at par.

The Dominion Sawmills, Limited, a merger of timber properties of British Columbia, was reorganized in 1912. The company's bonds were practically all held in Great Britain. A public issue of £1,027,500 seven per cent participating cumulative preference shares at 97½ was made in the London market in July, 1911. In the scheme of capital reconstruction of this company the existing six per cent first mortgage debentures, of which there were outstanding £930,000, part of a total of £1,000,000, were exchanged for an equivalent amount of five per cent debenture stock in the new company, to be known as the United Sawmills and Timber Company, while a bonus of three fully-paid $1 shares in respect of each £20 of debentures—say fiften per cent—were also allotted.

The $2,000,000 of cumulative seven per cent participating $100 preferred shares were replaced by an equivalent amount of six per cent income debenture stock, together with a bonus of four per cent in fully-paid $1 shares of the new company. The $4,201,200 of $100

shares exchanged on the basis of six new fully-paid $1 shares in respect of every $100 share now outstanding.

The capital of the old company was $5,000,000 seven per cent participating cumulative preference shares, $5,000,000 ordinary shares, and £1,000,000 six per cent first mortgage debenture bonds.

279. *Intricate financing of a reorganization.*—One of the largest and most important reorganizations in Canada of recent years was effected in 1913, when the Spanish River Pulp and Paper Mills, Limited, took over the Lake Superior Paper Company, Limited, necessitating a reconstruction of finances. The directors and shareholders of the Spanish River Company approved a plan authorizing the acquisition of the total issued capital stock of the Lake Superior Paper Company, Limited, consisting of $3,000,000 in preference shares and $5,000,000 in common shares.

Spanish River shareholders authorized the directors to effect an agreement between the company and a syndicate, whereby the syndicate agreed to deliver to the company 30,000 preference shares of the Lake Superior Paper Company of the par value of $3,000,000 and 50,000 common shares of the par value of $5,000,000 and to pay in cash to the company the sum of $900,000 in certain fixed instalments in consideration of the issue to the syndicate of 37,000 fully-paid preference shares of the company of the par value of $3,700,000 and 50,000 fully-paid common shares of the par value of $5,000,000, and the guarantee by the company of the payment of the principal and the interest and sinking fund upon existing issue of first mortgage bonds of the Lake Superior Paper Company, amounting to $50,000,000.

It was also proposed to increase the capital stock of the Spanish River Company to $20,000,000 by the crea-

tion of 70,000 additional preference shares and 60,000 additional common shares. Under the arrangement $900,000 cash was added to the working capital of the Spanish River Company.

This is how the securities of the Spanish River Company stood before and after reconstruction. In 1912, the Spanish River Company absorbed the Ontario Pulp and Paper Company, Limited.

SECURITIES OF THE SPANISH RIVER PULP AND PAPER COMPANY, LIMITED, BEFORE RECONSTRUCTION

	Authorized	Issued
Bonds, 6%	$2,500,000	$2,425,000
Ontaria Pulp	1,500,000	1,500,000
Preferred Stock 7%	3,000,000	3,000,000
Common Stock	4,000,000	3,000,000

SECURITIES OF THE S ANISH RIVER PULP AND PAPER COMPANY AFTER RECONSTRUCTION

	Authorized	Issued
6% first mortgage bonds	$2,500,000	
Redeemed by sinking fund	75,000	
		$2,425,000
6% bonds of Ontario Pulp and Paper Company, Limited	1,500,000	1,500,000
(Guaranteed by the Spanish River Pulp and Paper Mills, Limited)		
6% bonds Lake Superior Paper Company, Limited	5,000,000	5,000,000
(Guaranteed by the Spanish River Pulp and Paper Mills, Limited)		
7% cumulative participating preference shares	10,000,000	6,700,000
Common shares	10,000,000	8,000,000

The preference shares issued in exchange for the Lake Superior Paper Company shares were not to carry dividends until after July 1, 1914.

The total fixed assets of the Spanish River Pulp and Paper Company, including the Lake Superior Company plants, but excluding all timber areas, amount to approximately $13,000,000, while the total mortgage indebtedness against these assets consists of $8,925,000 six per cent first mortgage bonds. The surplus of current liquid assets, including pulp wood, paper, accounts, and the like, over and above current liabilities, after deducting the additional working capital, amounts to $2,100,000.

The company financing this reorganization made an arangement with the syndicate from which the Spanish River Pulp and Paper Mills, Limited, purchased the shares of the Lake Superior Paper Company, Limited, for the distribution among the preference and common shareholders of the Spanish River Pulp and Paper Mills, Limited, of $900,000 of the common stock of the Spanish River Pulp and Paper Mills, Limited, received by the syndicate on the sale of the shares of the Lake Superior Paper Company, Limited. Upon this distribution, shareholders received a bonus amounting without adjustment of fractions, to approximately ten per cent of their holdings of the preferred stock of the Spanish River Pulp and Paper Mils, Limited, and to twenty per cent of their holdings of common stock of that company.

280. *Further financing.*—Still further financing of this somewhat intricate reorganization is explained in the following quotations from letters issued by the secretary of the company and by the vice-president and general manager, respectively:

In the circular issued in July last it was proposed to raise additional working capital by a further issue of preferred shares, but this plan of financing has been changed, and an issue of term notes submitted, this issue providing the necessary capital for the requirements of the company, it being intended that during the currency of these notes, no dividends on the company's capital stock should be declared or paid. The re-arrangement of the finances of the joint companies has been effected by large financial interests in London, England, who deem it advisable to reduce the number of the board of directors to seven.

The preparation and publication of the report have had to be deferred pending a settlement of the basis of the new financial arrangement for the company. These have now been completed and will take the form of an issue of £300,000 of term notes, which have been underwritten at 95 by the London financial group, consisting of Messrs. Robert Fleming and Co., the British, Foreign and Colonial Corporation and their friends, the Canadian Agency, Limited, and Messrs. R. Niveson and Company.

The proceeds of this issue will put the company in funds and enable its operations to be carried on successfully.

281. *Financing which raised problems.*—Another important reorganization was that of the Canadian Coal and Coke Company. This caused considerable criticism and comment. The plan of reconstruction called for the creation of an issue of $4,000,000 seven per cent cumulative preference stock of the holding company which was to be offered par for par in exchange for bonds both of the Canadian Coal and Coke Company and of the subsidiary companies then in the hands of the public. All bonds still remaining in the treasury of the holding company, both its own and those of subsidiary companies were to be cancelled.

In a letter addressed to the bondholders of the com-

panies concerned, the secretary of each of them stated:

> The companies now require about $1,500,000 to pay off their existing liabilities and to carry on the works now in progress. It has been found impossible, in the prevailing financial conditions, to obtain the necessary funds by the sale of bonds ranking pari-passu with the existing issues. The work in progress has recently been carried out on the personal credit of the directors; but the time has arrived when the plan above outlined is rendered absolutely necessary. This plan will, we believe, protect all existing investments in the several companies, and place the consolidated company in a position to earn and pay at an early date seven per cent dividends on the cumulative preference stock now proposed to be created.
>
> The co-operation of all the bondholders and shareholders of the five companies is earnestly solicited in carrying out the proposed plan of reorganization and consolidation.
>
> A majority of the bondholders of each of the four operating companies have approved of the plan of reorganization recommended by the directors of the several companies.
>
> The result of carrying through the proposed plan will be that the present bondholders will have a preferred claim on the earnings of the company for their investment and the only charge ranking prior to the preferred shares will be the charge given for the new money necessary to bring the combined undertakings to complete success.

The same letter detailed the various obstacles and difficulties encountered by the companies and stated the basis of the transfer of the subsidiary companies and the reorganization and consolidation of the undertakings of those companies in the Canadian Coal and Coke Company, Limited, as follows:

1. That the holders of the six per cent mortgage bonds of the five above-named companies should convert the bonds held by them, on the basis of par of exchange, into

seven per cent cumulative participating preference stock of Canadian Coal and Coke Company, Limited.

2. That for the purpose of effecting this conversion the Canadian Coal and Coke Company, Limited, should create $4,000,000 par value of its seven per cent cumulative participating preferred stock.

3. That all the properties and assets of the companies, other than the Canadian Coal and Coke Company, Limited, should be conveyed to and vested in the Canadian Coal and Coke Company, Limited, freed from the charges and liens created by the outstanding bonds of the respective companies.

4. That the Canadian Coal and Coke Company, Limited, should assume, pay and perform all the debts, liabilities and obligations of each of the four companies whose properties are so conveyed to it, other than the liabilities created by the outstanding bonds of those companies.

5. That the Canadian Coal and Coke Company, Limited, should issue to each holder, other than itself, of ordinary shares of the capital stock of the four companies operating, whose properties are so conveyed to it, fully-paid ordinary shares of the capital stock of the Canadian Coal and Coke Company, Limited, on the basis of par of exchange.

6. The entire property and assets of all the four operating companies would then be vested in the Canadian Coal and Coke Company, Limited, free from any charges and liens, except such as may be created for the purpose of liquidating the current debts and liabilities of the five companies above mentioned.

282. *Question of bondholders' majority.*—Much criticism folowed the announcement of this plan, both by the Canadian financial press, by sections of the investing

public and by some holders directly interested. The chief bone of contention appeared to be that a bare majority of the company's bondholders could cancel the mortgage, the minority having to submit (although the mortgage was common to all) and accept the proposed stock issue. Of this phase, the *Montreal Financial Times* said:

We are entirely out of sympathy with the altogether too prevalent practice among Canadian industrial companies of exchanging bonds for secondary securities such as income bonds or preferred stock whenever it becomes inconvenient to carry them as a first mortgage claim any longer. The practice of conversion is being so general that it is apparently regarded as a matter of course not only by directors and "controlling interests," but by the investing public. If the thing goes on much longer it will be impossible to issue standard bonds in Canada, or at least to have them accepted, and valued, as such by the investor, for it is becoming a recognized thing that as soon as the money is safe in the treasury and the bonds are nicely distributed and the underwriters have "got from under," the mortgage is liable to be torn up with the utmost complacency and the supposed mortgage-holders to find themselves put off with a very secondary security.

We have no special opinion to express regarding the present re-financing plans of the Canadian Coal and Coke directors, the latest management to adopt the policy to which we take exception. We are discussing the system in a general way. The Canadian Coal and Coke Company is only following the prevailing practice—taking the line of least resistance, treading a path which has been beaten smooth for it by many similar corporations. But we do hope that in future the bondholders of Canadian industrial corporations will see to it that they are getting the kind of protection which their bonds purport to offer.

283. *As to a "bare majority."*—This stricture brought

a reply from Mr. C. H. Cahan, K.C., a distinguished Montreal lawyer, who in a letter to the same paper, said:

I would like to say that the particular clauses of that deed which you describe as "a flagrant example" are drawn in form and terms approved by the authorities of the London Stock Exchange.

Palmer, the acknowledged English authority, says of these provisions that: "Unless the majority is thus enabled, in special circumstances, to determine what is to be done on behalf of the whole body, the minority, however small, is placed in a position to dictate to the majority, and the interests of the whole of the majority imperilled by the ignorance, perverseness, fraud or cupidity of an insignificant minority, or the delay which would result if it were necessary to obtain the consent of every debenture holder."

Palmer adds that the draftsman who omits to insert some such provision, runs the risk of being accused of neglecting the best interests of the bondholders; and in view of the absence in Canada of a comprehensive insolvency act, and of the existing state of our law respecting the voluntary liquidation of companies, even stronger language might very appropriately be applied to any professional draftsman in this province who would exhibit, by such omissions, his own inexperience or negligence.

In the case of the trust deed and mortgage of the Canadian Coal and Coke Company, Limited, a quorum consisting of the holders of at least fifty per cent of the par value of the bonds outstanding must be present at the meeting of the bondholders, and if a poll is demanded, the resolution amending the provisions of the trust-deed and mortgage must be passed by three-fourths of the votes given on such poll. Holders of over one-half of the outstanding bonds may defeat the proposed proceedings by merely absenting themselves from the meeting; and, in any case, three votes must be polled in favor of the resolution to every single vote polled against it.

As to the merits of the reorganization scheme adopted by the Canadian Coal and Coke Company, Limited, and by its four subsidiary companies, it suffices to say that out of the several millions of bonds represented at the four meetings of bondholders, only one holder of $25,000 par value of bonds polled his vote against the scheme proposed.

I may add that the trust deed and mortgage, above referred to, was not drafted by me and that I have written the above on behalf of clients who are large holders of these bonds, and who do not think that your criticisms are well founded so far as they were applied by you to the terms of the trust-deed and mortgages of the Canadian Coal and Coke Company, Limited.

The financial journal in printing this letter replied with the following brief comment:

We cannot, however, agree with Mr. Cahan that the eminent English authority, Palmer, whom he cites, had any such conception of the rights of majority as is implied in the present procedure in the Canadian Coal and Coke Company, or that the fact that only one bondholder present at the meeting last week voted against the conversion proposals, is any proof that those proposals were in the interests of the bondholders as a whole.

These illustrations show the numerous phases of corporation reorganization in Canada. It is also seen that a keen interest is taken in every move of promoters and financiers in that country. So far as the Canadian Coal and Coke reorganization is concerned, the company was in trouble, and it is difficult to see how they could have escaped otherwise than they did. At the same time, the incident raised important points for consideration of corporation financiers.

QUIZ QUESTIONS

(*The numbers refer to the numbered sections in the text.*)

CHAPTER I

1. What are "non-stock" corporations?

2. What are "stock" corporations? For what purpose are they usually organized?

3. What is the most striking distinctive feature of the corporation compared with other forms of business association?

4. In what sense is "corporate entity" a fiction?

5. In what nations have corporations been prominent features of business life?

6. Show briefly how the use of corporations has spread in recent years.

7. State how and why the corporate form is well adapted to raising large amounts of capital.

8. In what sense is a corporation more permanent than a partnership or than individual proprietorship? How is this attribute an advantage?

9. Show how and why the corporate form better lends itself to an efficient, centralized control of a business than the partnership form.

10. Can an interest in a corporation be more readily transferred from one person to another than an interest in a partnership? Why?

11. What is the principle of limited liability of corporate stockholders? Is the principle universally applicable? Name the principal advantages of the corporate form of organization.

12. Name the principal disadvantages of the corporate form. Mention two kinds of enterprises in which these disadvantages outweigh the advantages.

CHAPTER II

13. What are the legal instruments that define and control a corporation's activities?

14. How far is the common law applicable to corporations?

15. Is it important to consider the provisions of the constitution of the state in which a corporation is formed? Why?

16. Discuss the relative advantages of two methods of securing authority to incorporate.

17. What is a charter? What is a certificate of incorporation? What are articles of incorporation? What information should a charter ordinarily contain?

18. Draw up a charter for a company (imaginary or otherwise) following the model given in the text.

19. Can a new corporation assume a name which has already been adopted by a corporation chartered in some other state? Do any of the states prescribe any part of the names of corporations organized under their laws?

20. Why is it important to state the purposes for which a company is formed fully and carefully in the charter? Why did the New Jersey Court of Errors

and Appeals hand down a decision adverse to the railroad company in the instance cited in the text?

21. What is the minimum number of incorporators in most states?

22. What topics are usually considered in the by-laws of a corporation? Draw up a brief set of by-laws for a company (imaginary or otherwise) following the model given in the text.

23. What are the usual by-law provisions as to stock, meetings, officers, dividend payments and by-law amendments? How may new rules of action be adopted without the formality of amending the by-laws?

CHAPTER III

24. What are the four fundamental rights of the body of stockholders of a corporation? May a board of directors ordinarily sell the assets of their corporation without the consent of the stockholders?

25. Name the four fundamental rights of each individual stockholder. What is a proxy? Write a proxy conferring the right to vote in favor of a proposed amendment at a special meeting called for the purpose of considering the amendment. When is a proxy irrevocable?

26. Can stockholders force a board of directors to declare a dividend, provided the company is admitted to have earned large profits? What is meant by the "right to dividends"?

27. Does a stockholder have a legal right to inspect the books of his company? How does the movement in favor of publicity of accounts work in favor of stockholders?

28. What are the two chief universal liabilities of stockholders?

29. What are the two classes of creditors? Has either class a right to interfere in the internal management of the debtor corporation?

30. What are "dummy" directors? How are they sometimes kept under control?

31. What in general are the powers of a board of directors? May those powers be delegated? Under what circumstances do directors become liable for loss suffered by their corporation?

32. Why is it stated in the text that the corporate form is "almost ideally adapted, so far as efficiency and economy go, to the conditions of present-day industry"?

CHAPTER IV

33. By virtue of what legal principle do corporations chartered in one state of the Union extend their operations to other states? Give the gist of the decision of the Supreme Court in the case of The Bank of Augusta vs. Earle.

34. May a state regulate in any manner corporations doing business within its borders, but chartered in another state? If so, how?

35. Give three reasons in favor of securing a charter from the state in which a corporation has its principal office. Why are not these reasons decisive in all cases?

36. From the tables given in the text estimate the organization fees and the annual franchise taxes of a corporation with $50,000 capital stock in New Jersey, New York, Delaware, Maine and South Dakota. What

other expenses will probably be incurred in starting a new company?

37. Name four states which have liberal incorporation laws.

38. Why is it desirable to secure a charter in a state which has an established and well-adjudicated corporation law?

39. Name three states which bear poor reputations as states of incorporation. Name three states which bear good reputations.

40. If you were about to incorporate a manufacturing company, located in Massachusetts, designed both to operate a plant and to buy up the stock of several competing companies, the capitalization to be $2,000,000, in what state would you take out a charter? What other states would you be inclined to consider favorably? Base your answer on the data given in the text and state your reasons fully. An excellent method of getting familiar with the main features of the various state laws is to make up a number of similar hypothetical cases and consider each one carefully.

41. What is a "subscription contract" and when is it used?

42. What is meant by the statement that a capable lawyer can generally fit out any corporation with the exact powers and privileges that will prove most advantageous.

43. Discuss the Companies' Act of the Dominion. How is a charter forfeited? What are the provisions of the Companies' Act in regard to liability of shareholders? What are the powers and limitations of the directorate under this act?

44. What conditions complicate the incorporation of companies in Canada?

CHAPTER V

45. In your opinion should stock certificates be made fully negotiable? Give your reasons in full.

46. What is the "par value" of a share of stock? The "market value"? Is there any good reason for the custom of giving shares a nominal value in money?

47. Define fully "preferred stock," showing wherein the preference may consist.

48. Name and discuss four uses of preferred stock. What is "voting stock"?

49. What is the object of "cumulative voting"? How is that object attained?

50. What is a "voting trust"? What is the usual plan of organization? What is the usual object in establishing a voting trust?

51. Describe the formation of the Dominion Steel and Coal Corporation, Ltd. In your opinion was this the best way to settle the trouble between the two original companies?

CHAPTER VI

52. Define "quasi-public corporations," "private corporations," "close corporations."

53. What is a "parent company"? What is the difference between a "parent company" and a "holding company"?

54. Why does a holding company usually aim to secure more than a bare majority of the stock of its subsidiary companies? What is the distinction between the ordinary balance-sheet of a holding company and its "consolidated" or "general" balance sheet?

55. Under what plan were the early "trusts" organized? Why do most "trusts," so-called, now take the form of holding companies?

56. Taking the chart of organization of the Interborough-Metropolitan Company, show what relation of ownership and control exists between the New York City Railway Company and the Interborough-Metropolitan Company.

57. How many companies are directly controlled by the Standard Oil Company of New Jersey? How many indirectly?

CHAPTER VII

58. Enumerate from memory the principal topics covered in the first six chapters of this book.

59. What are the six sources of corporate funds? In what sense may profits be called a possible source of funds? In what sense do trade creditors supply corporate funds? Can a corporation manager or promoter ordinarily sell the stock or bonds of his company to a bank? If not, why not?

60. What are the important classes of investors?

61. How would you distinguish between an "investment" and a "speculative" security?

62. What are the important classes of buyers of speculative securities?

63. Why is it desirable that a corporation should borrow a considerable proportion of its funds? What proportion of the funds used by the five companies named in the text are borrowed?

64. What kinds of securities ordinarily will a corporation offer in order to secure funds from (a) trade

creditors, (b) banks, (c) the investing public, and (d) the speculative public? Name and describe the six important groups of corporate assets. What securities may be issued corresponding to each group? In determining what securities a corporation may issue, are the earnings of the corporation, as well as its assets, taken into consideration? If so, how?

65. What proportion of the corporate capitalization for the year mentioned in the text is invested in corporations capitalized at more than a million dollars?

66. What is the Canadian attitude toward the participation of banks in the flotation of security issues? What is the position of the bank if the flotation is successful? Unsuccessful?

67. How does a Canadian bank make loans to corporations?

68. What conditions make it comparatively safe for a Canadian bank to make large loans to corporations?

CHAPTER VIII

69. How are corporate funds secured from trade creditors? What two qualifications limit the general statement that a corporation should buy as much as it can on credit? What is a conservative percentage of accounts, bills and notes payable to quick assets?

70. What are the main points that will be considered by a careful banker in determining how much credit he is willing to extend to a corporation?

71. What are the essential features of a valid negotiable promissory note? What is the chief objection to using short or medium term notes sold to the public as a means of securing corporate funds? Under what

circumstances is it good financial policy for a corporation to issue such notes? In general should the short-time obligations of a corporation ever be based on the corporation's permanent assets?

72. Under what conditions are short-term notes a desirable means of securing money? What sort of corporations use this method of raising money?

73. Describe the short-term loan made by the Canadian Northern Railway Co.

74. What is the attitude of Canadian bankers toward short-term notes? Why?

75. Discuss the problems created by short-term loans.

CHAPTER IX

76. What three opinions are prevalent as to the chief factor that determines the value of fixed assets?

77. What are the characteristic features of a mortgage? What is a mortgage bond? What is a mortgage deed of trust?

78. What are the essential and usual provisions of a corporate deed of trust?

79. Define "closed," "open-end" and "limited open-end" mortgage deeds of trust. Which of the three types is generally the best? Why?

CHAPTER X

80. Give from memory the principal descriptive words applied to corporate bonds indicating (a) their security, (b) their purposes, (c) their manner of payment and (d) their conditions of redemption.

81. What is a junior mortgage bond? How is the fact that it is a junior bond sometimes disguised?

82. What are sinking fund bonds? What are the principal objections to their use?

83. What are collateral trust bonds? Why may they sometimes be sold more readily than the securities on which they are directly based? How may they be used to finance the process of buying control of subsidiary corporations?

84. What is an equipment trust bond? Why are they so highly regarded by investors?

85. In what way does the Grand Trunk Railway short-term loan of July, 1913, resemble an issue of equipment notes?

CHAPTER XI

86. Compare English with American practice with reference to the use of debenture bonds. What reasons lead to the issue of debenture bonds from time to time by some corporations in this country?

87. What are income bonds? What is the chief objection to their use?

88. Define "participating," "profit sharing" and "joint" bonds and "receiver's certificates."

89. What are registered bonds? Coupon bonds? What are the advantages and disadvantages of each form? What are redeemable bonds?

90. What are convertible bonds? What are their advantages and disadvantages to the corporation?

CHAPTER XII

91. What is a promoter? Does he have a legitimate and useful function or not? Give your reasons.

92. What is meant by the promoter's "discovery" of a proposition? Illustrate in detail with reference to some hypothetical case, such as a new gold mine in Alaska or a proposed creamery in a small country town.

93. What is meant by "assembling" a proposition? Illustrate in detail with reference to the same hypothetical case used in the previous question.

94. What are the first steps in financing a proposition? What is the advantage of carrying the development of the proposition as far as practicable before asking outsiders to supply funds?

95. Why should a promoter usually endeavor to raise more money in advance of complete development of a proposition than he expects will be needed?

96. Why is it usually better for a promoter to sell to a large number of small buyers than to a small number of large buyers?

97. To whom should a promoter go first, generally speaking, for funds? Why?

98. Show how the principles of promotion laid down are applied in the illustration given in the text.

CHAPTER XIII

99. Why are professional promoters usually unsuccessful in the long run?

100. Why do lawyers and bankers in small communities do a considerable amount of promotion work? To what extent do the large metropolitan bankers and promoters enter the field of promotion?

101. What are the advantages of engineering firms as promoters?

102. Is a promoter in any sense an agent of his corporation? A promoter buys a manufacturing plant for

$10,000 and sells it to a corporation which he promotes for $20,000, representing this latter sum to be the price he paid for the plant: is he legally entitled to his $10,000 profits? If not, what course may he pursue in order to evade the law?

103. Why is it difficult to enforce the principle that misleading statements by a promoter are fraudulent?

104. A promoter makes a contract on behalf of his corporation which is not yet formed: how may the corporation become bound by this contract without formally ratifying it?

105. How did the promoters of the Rubber Goods Manufacturing Company receive their pay? Of the American Smelting and Refining Company? In general what two plans of determining a promoter's profits are most commonly used?

106. What are the chief risks and tasks that a promoter must generally assume?

107. Do you think that promoters in general are or are not overpaid? Give your reasons.

CHAPTER XIV

108. Why is there a strong tendency toward consolidation among small as well as among large industrial establishments?

109. What are the principal difficulties that are apt to confront a promoter who undertakes to consolidate several existing concerns?

110. Describe briefly the process of "discovering" a consolidation.

111. What is the usual method of "assembling" a consolidation? What is a "basis of consolidation"? What are the characteristic features of the two agreements cited in the text?

112. Why is it important for the promoter of a consolidation to consider with especial care the means of providing his new corporation at the outset with sufficient cash?

113. Why does the promoter of a consolidation generally try to raise cash by means of a bond issue? How may he manage to dispose of bonds issued by a new corporation with small or uncertain assets?

114. How does the problem of forming a large consolidation differ from the problem of forming a small consolidation?

115. What is the usual basis of consolidation or exchange and how is it determined?

116. What was the basis of exchange in the formation of the Interborough-Metropolitan Company? In what respects was it faulty?

117. What has been Canada's experience in forming consolidations? What are the advantages of consolidations in Canada as cited by the promoters?

118. What is the basis of consolidations ordinarily? Describe some prominent amalgamations.

119. How are stocks watered in forming a consolidation?

120. What has been the usual result in the reorganization of overcapitalized industrial consolidations in Canada?

121. Describe the formation of the Canada Transportation Lines, Ltd. Were the Canadian promoters well paid for their share in this consolidation?

CHAPTER XV

122. What were the conditions under which the steel business of the United States was conducted in the decade, 1890-1900?

123. What were the chief steel companies in the field in 1901 and why had most of them been formed in the three years, 1898-1901?

124. What is meant by "integration" of an industry? How did this factor operate to bring about the formation of a great steel combination?

125. Why was not the promotion of the United States Steel Corporation an especially difficult task? Why were the four Moore companies included in the combination? What was the original capitalization of the United States Steel Corporation?

126. Was the prospectus issued by the promoting syndicate misleading? How much cash did the syndicate furnish?

127. What were the approximate profits of the promoting syndicate?

128. What percentage of the stock of the underlying companies was secured by the Steel Corporation? Give from memory a list of some of the important assets of the corporation.

129. What have been the principal additions to the Steel Corporation? Give briefly the terms of the Hill ore lease and of the Tennessee Coal, Iron and Railroad Company deal. What is the approximate cost of the steel rail mill at Gary, Indiana?

130. Describe briefly the preferred stock conversion plan of 1902. What objections were raised to the plan? What important changes in the interior financial organization of the corporation have been made?

131. Give briefly the argument tending to show that the Steel Corporation is greatly over-capitalized. Give briefly the argument on the other side of the question.

132. What in general is the policy of the Steel Cor-

poration toward its employés? Do the subsidiary companies of the corporation compete with each other?

133. What are the principal outstanding securities of the Steel Corporation? What reasons may be given for expecting that these securities over a period of years will rise in value?

CHAPTER XVI

134. Name the four methods of selling corporate securities.

135. What are the characteristics of a good prospectus? Why are statements in speculative prospectuses usually vague?

136. Show that the characteristic features of speculative prospectuses are present in the example cited in the text.

137. What are the characteristics of strictly investment prospectuses? Is it safe to assume that these characteristics are never apparent except when the security offered is of the highest grade?

138. What would be the characteristics of an ideal prospectus?

139. What are the advantages and disadvantages to a corporation of selling its securities through large bond and banking houses?

140. What are the characteristics of large, high-class banking houses in contrast to disreputable concerns and what are the essential factors that make a proposition acceptable to them?

141. What are the usual banking house methods of selling securities? Do such houses guarantee the safety of the securities they sell?

142. Where is the big market for Canadian securities?

143. Why is it important that the British investor be given full and correct information?

144. What information should be given in the prospectus?

145. What is the tendency of the United States market for Canadian securities? Why?

146. Which is Canada's richest rural community? What is its principal rural industry? How has it been financed?

CHAPTER XVII

147. Name the principal stock exchanges of the United States.

148. What percentage of the securities handled on the New York Stock Exchange are "listed"? What are the requirements for listing?

149. What is the "curb" market and what classes of securities are bought and sold in this market?

150. Describe briefly the method of handling transactions on the floor of a stock exchange.

151. What is the relative importance of speculative as compared with investment business, and what function is performed by the speculative business?

152. Describe the process of buying securities "on margin."

153. Describe the process of selling securities "short."

154. What are the characteristics of stock exchange houses in contrast to "bucket shops"?

155. Into what three classes may Wall Street speculators be divided?

156. Give from memory a brief review of the characteristics of the Wall Street security market.

157. What measures may be taken to stimulate speculative interest in a security that is about to be issued?

158. With what object is a syndicate frequently formed to assist in the flotation of a security?

159. By the use of what methods may the price of a stock market security be manipulated and kept under control?

CHAPTER XVIII

160. What is underwriting? How did the practice and the word originate?

161. What are the chief advantages to the corporation in having its new issues underwritten?

162. What are the advantages to the buyers of securities?

163. When is underwriting inadvisable? What is your opinion as to the merits of the Pennsylvania Railroad controversy referred to in the text? Give your reasons.

164. Why do the underwriting houses in almost every case band themselves together into syndicates?

165. Describe three types of syndicates.

166. Describe the type of syndicate in which the sale of the security is pooled.

167. Describe the type of syndicate in which the underwritten issue is distributed among the members of the syndicate.

168. Name some of the principal underwriting houses. What is the distinction between a bank and a banking house?

CHAPTER XIX

169. Why are underwriting syndicate agreements frequently quite informal?

170. Make an abstract showing the principal points covered in the agreement of the syndicate formed to underwrite the preferred stock conversion of the United States Steel Corporation.

171. Mention two general characteristics of underwriting agreements.

172. With what three classes of corporations do underwriting syndicates deal?

173. What are the peculiar problems and difficulties involved in underwriting the security issues of new or speculative corporations?

174. Review from memory the example of speculative underwriting given in the text and make sure that you understand thoroughly all the operations involved. What conditions made possible the construction of a new plant in this case wholly with borrowed funds? What principles followed in this case are applicable in all cases where it is desired that an undeveloped corporation should borrow as much as possible?

CHAPTER XX

175. What mistake is frequently made in the investment of the original capital funds of a corporation?

176. What are the advantages of the installment method of getting funds for a corporation only as the funds are needed?

177. What are the disadvantages of this method?

178. What are the other possible methods of getting cash as needed, when the total amount necessary cannot be accurately foreseen?

179. What considerations determine how large an amount must be invested by a corporation in fixed capital? What is working capital?

180. What are the four forms which working capital may take?

181. What factors determine how large an amount of working capital should be carried by a corporation?

182. Of the companies named in the text, which one has the largest percentage of working capital to gross business? Can you suggest any reason?

183. What are the five factors that immediately affect working capital and determine its amount? Why do railroads require only a small proportion of working capital?

184. About how much working capital did the Pennsylvania Railroad Company carry in 1908? Why was this amount greater than that carried bv most railroad companies?

185. Why is it of the utmost importance that a corporation should be supplied with the proper amount of working capital?

CHAPTER XXI

186. Draw up from memory a model corporate income statement, arranging the items in their proper order.

187. By what common methods may a company's statement of gross earnings be padded?

188. What expenditures and what reserves should

always be included under the head of operating expenses?

189. What are the causes of depreciation? What is a depreciation reserve? What method of allowing for depreciation has been in common use among steam and electric railroad companies? Is a depreciation reserve usually set aside as a separate sum to be invested outside the corporate business?

190. Why should "income from other sources" be stated separately? Why should cumulative preferred dividends be paid regularly, if practicable?

191. Should a corporation ordinarily pay out all its profits in the form of dividends to its stockholders? If not, why not?

192. What four factors determine the amount of profits? What industries are apt to have the most regular profits? Why are the profits of railroad equipment companies so variable?

193. Why is it desirable that a corporation should establish and maintain from year to year a regular dividend rate? How may regularity of dividends be secured in spite of irregularity of profits?

194. Why is great prudence and foresight on the parts of the directors in declaring dividends essential to the best interests of a corporation?

CHAPTER XXII

195. What are the two important classes of betterments?

196. What are the three important sources of funds for betterments?

197. What are the advantages of providing for betterments by appropriations from earnings?

198. What are the two objections to this method?

199. What three motives may lead stockholders to oppose a policy of providing for betterments by appropriations from earnings? How do corporation officers sometimes manage to follow this policy without the consent of even a majority of stockholders?

200. Review briefly from memory the case of the Lehigh Valley Railroad Company and show how President Walters for some years pursued the policy referred to above.

201. Show how the Union Bag and Paper Company is now profiting by reason of having previously pursued this policy.

202. When and how may funds for betterments safely be borrowed?

203. What policy as to provision for betterment expenditures is followed by the Pennsylvania Railroad?

204. What are the comparative merits of bond and of stock issues as means of raising funds for betterments?

CHAPTER XXIII

205. Define "surplus."

206. Give and discuss briefly four sources of surplus.

207. What is the fifth source of surplus? Can a surplus be built up to any considerable amount by this method?

208. What was the policy of most of the industrial trusts as to surplus in the first few years of their existence? What were the results of their policy?

209. How may a surplus be invested? What general principle should be followed?

210. What is meant by using the surplus as a "rainy day fund"? What companies follow this practice? What is the argument in its favor? What are its disadvantages?

211. What is the usual practice in this country with reference to the use of a surplus?

CHAPTER XXIV

212. What should be the effect on dividends of putting a surplus back into the property of a corporation? Is the effect ever to increase dividends in a proportion greater than the proportion of surplus so invested to the original corporate capital? If so, when?

213. How may stock-watering be a method of distributing a surplus to stockholders? Give an illustration. Why is it that a stock paying a regular dividend of 4 per cent often sells for more than half as much as a stock paying an equally regular and certain dividend of 8 per cent?

214. What are subscription privileges? How may they be used as a method of distributing surplus?

215. How does a subscription privilege give an opportunity for cheap investment? What four methods may be used by stockholders in order to secure quick cash profits?

216. What is the method known as the "subsequent sale"? What are the objections to its use?

217. What is the "short selling" method? What is the objection to its use?

218. What is the method known as "sale of old stock"? Why cannot it always be used?

219. What is the method known as "sale of rights"?

What is meant by a "right" in New York? What does the same word mean in Philadelphia? What is the objection to the use of this method?

220. What factors determine the theoretical value of a right? What is the formula commonly used on the New York Stock Exchange? Why is the market value of a right usually less than its theoretical value?

221. Is the granting of privileged subscriptions a method of stock watering? Are they objectionable on that account?

CHAPTER XXV

222. What good reason can you give for taking up the study of corporate manipulation?

223. Is it true that the corporate form favors manipulation? If so, why?

224. Is any force at work in the financial and industrial world which has a strong tendency to check manipulation?

225. What four classes or bodies of persons may endeavor to manipulate a corporation for their own benefit?

226. How may high salaries be used as a method of manipulation?

227. How may the power to bind a corporation by purchases and contracts become a means of manipulation? Is it usually possible to find a legal remedy or punishment?

228. How may the power to form new companies to handle especially profitable business be used as a method of manipulation? How was this principle applied by Commodore Vanderbilt?

229. How may a corporate officer manipulate a corporation by reason of having "inside" information.

230. Is there reason to think that the use of these four methods of manipulation is not uncommon?

231. Why have Canadian companies been comparatively free from manipulation?

CHAPTER XXVI

232. Why do not directors who wish to manipulate a corporation in their own interest enrich themselves by voting exorbitant fees to themselves? What four methods do such directors commonly use?

233. How may directors misuse their power to make contracts on behalf of their corporation? Illustrate by reference to the case of the Minnesota railroad company cited in the text.

234. Why do not the courts interfere in such cases?

235. How may directors manipulate by forming new companies or transferring credit or assets of their company to some other company? Give an illustration.

236. State a few methods of juggling the accounts of corporations which are not infrequent. How may directors profit by juggling the accounts of their corporation?

237. What is meant by "window-dressing"? How may it be used by directors as a method of manipulation?

238. What remedies for this kind of manipulation may be suggested?

239. How may directors secure gain for themselves by inflicting loss or even bankruptcy on their corporation? Give two illustrations.

240. Review the essential features of the case cited in the text. How might the manipulation of the corporation in this case have been prevented?

241. What faults are there in the form of the Annual Statements in Canada?

242. What information should there be in an annual statement of a corporation?

243. What is the attitude in Canada toward quarterly reports? Why?

CHAPTER XXVII

244. How may stockholders fraudulently secure profit for themselves at the expense of the creditors of the corporation?

245. What are the essential facts in the well-known case of Chicago and Alton Railroad Company?

246. How may subsidiary companies be used as a means of manipulatitng a corporation and defrauding creditors? Illustrate.

247. Review the main facts in the Central of Georgia Railway case cited in the text.

248. Show how the minority stockholders in a corporation may be "squeezed" by wilful mismanagement on the part of the majority stockholders and illustrate by reference to the case of the Olympic Theatre Company cited in the text.

249. Review from memory the series of transactions in the real estate proposition cited in the text and show exactly how the minority stockholders in the Long View Land Company were defrauded.

250. Review from memory the series of operations carried on by L. A. Ehrenbahn cited in the text and

show how they all worked in favor of the manipulation of his deceased brother's estate in his own interest.

251. Mention four measures preventive of manipulation that should be taken by honest stockholders.

CHAPTER XXVIII

252. Distinguish between "true" and "legal" insolvency.

253. Mention four possible causes of true insolvency.

254. What are the chief causes, according to Bradstreet's table, of legal insolvency? What is the real meaning of the phrase "lack of captial" when used in this connection?

255. What were the two causes, according to the *Wall Street Journal,* of the failure of the Detroit, Toledo and Ironton Railway Company in 1909?

256. Mention three immediate causes of legal insolvency in addition to "lack of capital."

257. What is bankruptcy? Can a corporation become a voluntary bankrupt? Can all corporations become involuntary bankrupts? Is dissolution of the corporation a common method of handling insolvency? If not, why not?

258. What is a "bill in chancery"? By whom may it be presented? How may a friendly receiver for a corporation be obtained? What courts have jurisdiction in cases of corporate insolvency and receiverships?

259. What, briefly stated, are the duties of the receiver of a failed corporation?

260. From what source does he obtain his authority? How are his powers limited? May he incur debts binding on the insolvent corporation? Does he receive a fee?

261. What is the principal cause of failures in Canada? Are there many corporation failures in Canada? What percentage of failures are charged to individuals?

CHAPTER XXIX

262. Why is it usually necessary and desirable to reorganize large insolvent corporations rather than to sell their property and distribute the assets among the creditors?

263. Why is the formation of committees usually the first step in reorganization? How are these committees appointed? How much authority do they possess? How may a general reorganization committee be formed?

264. Why are bondholders usually ready to agree to a reorganization rather than foreclose and force a sale and distribution of assets?

265. What are the main problems and difficulties that confront a general reorganization committee? How are the relative standing and value of the various issues of mortgage bonds and other claims on the corporation determined? What concession is usually made to the stockholders of the corporation?

266. Name the four main objects of every reorganization. Why is it necessary usually to raise considerable amounts of cash?

267. What are the three possible methods of raising cash? Why do almost all reorganizations of insolvent corporations involve assessments on security holders? How large may the assessments on stockholders be made? Under what circumstances may bondholders be induced to pay assessments?

268. What three classes of fixed charges are usually reduced in reorganization? What threat may be used to force an acceptance of a reasonable reduction? What principle is usually followed in determining the maximum total amount of fixed charges to be imposed upon the reorganized company?

269. How are bondholders usually compensated for the reduction in their yearly interest? What is the effect on the total capitalization of the company? What factors determine whether or not the reorganized company shall operate under the charter of the old company? Why is a voting trust frequently formed at the time of organization?

270. Summarize briefly from memory the principles of reorganization laid down in this chapter.

CHAPTER XXX

271. Sketch from memory the growth of the Santa Fe System. What were the effects on the company's financial strength of the rapid expansion in the years 1884-1888?

272. What were the main results of the reorganization of 1889? What were some of the events that led up to the failure of the company in 1893?

273. What was the substance of the so-called English plan of reorganization? Why was it not adopted? What were the main features of the plan that was finally adopted? What have been the results of this reorganization?

274. Sketch from memory the growth of the Rock Island System.

275. Outline the plan of reorganization brought for-

ward in 1902. What was the prime object of this reorganization? Was that object attained? Show how control of the Rock Island System may have been secured by the Moore crowd without any permanent outlay.

276. Why did the Westinghouse Company fail? What was the main problem that confronted the reorganization committees? What were the main features of the plan adopted?

277. How may the necessity for future reorganization be guarded against when forming the consolidation?

278. Describe the reorganization of the Dominion Sawmills, Limited.

279. Describe the financing of the absorption of the Lake Superior Paper Co., Limited, by the Spanish River Pulp and Paper Mills, Limited.

280. What further information is given in the letters issued by the executives of this company?

281. What problems are raised by the reorganization of the Canadian Coal and Coke Co.? What were the terms of its reorganization?

282. What was the principal objection to the plan?

283. In view of Mr. Cahan's letter do you think the objection is justified?

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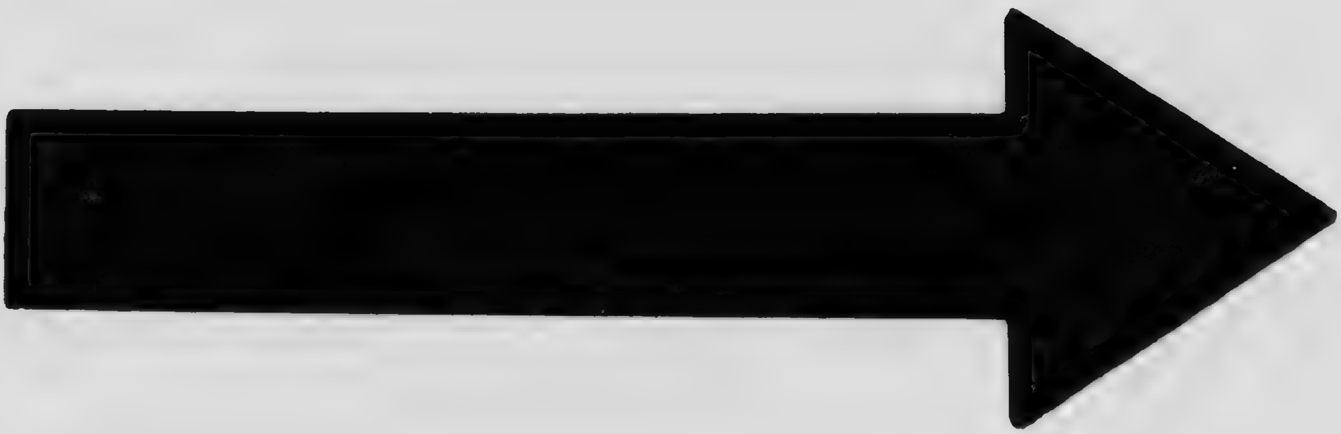

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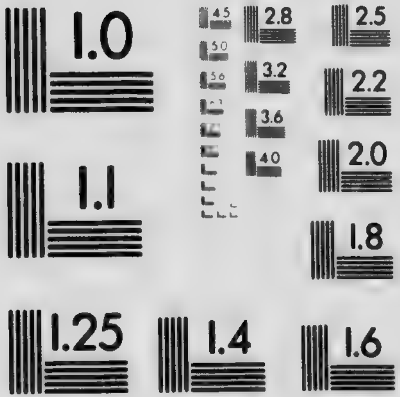

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